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PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE PROBLEMS IN THE SAVINGS AND LOAN INDUSTRY AND THE POTENTIAL THREAT TO THE INSURANCE FUND PROTECTING S&L DEPOSITS

PART IV OF IV

MARCH 14, 15, 16, AND 17, 1989

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PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART IV OF IV

TUESDAY MARCH 14, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Cranston, Dixon, Graham, Bryan, Garn, Gramm, Bond, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

I want to welcome our witnesses this morning and I will introduce them just a little bit later.

Today is our 15th day of hearings dealing with the problems facing the Federal Savings and Loan Insurance Corporation and system.

Last October, Senator Wirth of Colorado and Senator Graham of Florida, members of this committee, sent a letter together with a number of the other committee members, to Comptroller General Bowsher asking that the GAO examine a sampling of FSLIC-assisted sales of failed savings and loan institutions. That letter which was dated October 20, 1988 and which I will now make part of the record, requested that the GAO concentrate on two fundamental issues—the bidding and selection process and the transactions themselves.

WILLIAM PROXMIRE WISCONSIN CHAIRMAN
ALAN CRANSTON CALIFORNIA
DONALD W RIEGLE JR MICHIGAN
PAUL S SARBANES MARYLAND
CHRISTOPHER J DODD CONNECTICUT
ALAN J DIXON ILLINOIS
JIM SASSER TENNESSEE
TERRY SANFORD NORTH CAROLINA
RICHARD C SHELBY ALABAMA
BOB GRAHAM FLORIDA
TIMOTHY E WIRTH COLORADO
JAKE GARN UTAH
JOHN HEINZ PENNSYLVANIA
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LAMAR SMITH REPUBLICAN STAFF DIRECTOR AND ECONOMIST

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

October 20, 1988

The Honorable Charles A. Bowsher
Comptroller General of the United States
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Bowsher:

A number of recent Federal Savings and Loan Insurance Corporation (FSLIC) assisted sales of failed savings and loan institutions that have been authorized by the Federal Home Loan Bank Board (FHLBB) have not been publicly scrutinized and fully analyzed. We therefore request that the General Accounting Office select five transactions, taking into consideration differences in location, size, and characteristics of the assistance and examine these transactions in detail.

In examining these transactions, we ask that you concentrate on two fundamental aspects: the bidding and selection process and the transactions themselves. In regard to the first aspect, we ask that you consider the universe of potential bidders contacted, bid instructions, initial bids, the evaluation of the bids, and the negotiation and selection process plus any rebidding that occured after a bid was selected and then interaction of the FSLIC staff with the Bank Board members and staff.

Next, we ask that you examine details of the selected transactions. Aspects to be analyzed should include: a comparison of the costs of the transactions with the costs of liquidating the involved failed thrift; the methods used by FSLIC to assure itself that the resolution of the failed thrifts is in fact final and that further FSLIC assistance will not be required; the risks accepted by FSLIC, including those in providing yield guarantees and capital loss coverage on covered assets; and the steps FSLIC is taking to protect itself against, and compensate itself for, the risks it is accepting.

In addition, we would like you to provide comparable basic information on the background and experience of the senior officials at the Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Home Loan Bank Board.

We feel this information is necessary to properly evaluate whether changes should be made in the policies and procedures of the Bank Board so that it may better serve the American public.

We would appreciate your initial response to this request by March 1, 1989.

Sincerely,

Bob Graham
Bob Graham

Tim Wirth
Timothy E. Wirth

Don Riegle
Donald W. Riegle, Jr.

Jim Sasser
Jim Sasser

William Proxmire

Lawton Chiles
Lawton Chiles

GAO
United States
General Accounting Office
Washington, D.C. 20548

General Government Division

November 3, 1988

The Honorable Bob Graham

The Honorable Timothy E. Wirth

The Honorable Donald W. Riegle, Jr.

The Honorable James Sasser

The Honorable William Proxmire

The Honorable Lawton Chiles
United States Senate

This letter is to confirm the agreements reached between the General Accounting Office and your staff regarding the scope of the work to be done in response to your letter of October 20, 1988. In that letter you requested that the General Acounting Office undertake a study of five transactions authorized by the Federal Home Loan Bank Board (FHLBB) that involved the sale of failed savings and loan institutions. As you requested, we will look at such transactions with respect to the bidding and selection process and with respect to the soundness and appropriateness of the transactions themselves.

You asked that we select transactions so as to give some diversity with respect to geographic location, size, and characteristics of the assistance. We have tentatively selected three transactions that are part of the Southwest Plan (Southwest Savings, Olney, and Gibson/LSST); the series of transactions relating to Bell Savings in the San Francisco district; and one transaction (Home/Mutual/Galva) in the Chicago district.

With respect to the bidding and selection process, our review will include examining the following documents:

1. The bid instructions.
2. All initial bids.
3. Subsequent revisions to these bids.
4. All evaluations of these bids (including their cost) prepared by or for FSLIC and documents relating to the evaluations and selection.
5. Other documents, including those prepared by the FHLBB's Office of the General Counsel, relating to the bid and selection process, as well as those documents prepared by the regional home loan banks.

The following issues will be addressed with respect to the bidding and selection process:

1. Is there evidence that FSLIC is limiting Southwest Plan packages to certain bidders rather than contacting all potential, legitimate acquirers of Texas thrifts.

2. In any of these cases, has FSLIC chosen not to accept the lowest bid. What reasons does the FSLIC give to justify not accepting the lowest bid.

3. Do the failed thrifts which are being sold have franchise value and if so, how does FSLIC determine the franchise value.

4. What process does FSLIC use in determining with whom it will negotiate to resolve a failure. What factors influence the choice of bidders. Is this process quantified or documented.

The following issues will be addressed, using available information, with respect to the transactions:

5. Given the large amount of assistance provided in Southwest Plan transactions, on what basis does FSLIC believe the selected transactions are cheaper than liquidation. Does FSLIC use different costing assumptions for Southwest Plan cases than for non-Southwest Plan cases. How are tax benefits treated and what are the implications.

6. Did each acquiring thrift meet regulatory net worth requirements both before and after the acquisition. What was the net worth as measured under generally accepted accounting principles ("GAAP") before and after each acquisition.

7. What are the types and extent of assistance given in the selected cases.

8. How much downside risk do the acquirers take in these transactions. Does the FSLIC have any realistic expectations of upside potential. What economic scenario would have to occur to generate such upside potential.

9. How does FSLIC evaluate the acquirer's financial viability both before and after the acquisition, their integrity, management competence and integrity, and business plans. Do these acquirers intend to operate their savings and loans to provide home finance to the communities in which they are located or do they have other objectives.

10. What mechanisms are in place to monitor the newly created entities.

11. Is there any evidence that FHLBanks are making advances to acquirers to facilitate these transactions or that collateral considered inadequate is being accepted for the advances.

In addition, we will provide basic information on the background and experience of the most senior officials at the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board.

As you requested, we will provide our analysis of these transactions to you in the form of a briefing, with briefing material attributable to GAO, by March 1, 1989. We will inform you if we encounter difficulties in obtaining needed information from the FHLBB or any of the entities in the FHLB System.

Finally, as you are aware, Congressman Henry B. Gonzalez previously asked the General Accounting Office to undertake work related to the Southwest Plan. Accordingly, your staff has agreed that our briefing to you with respect to the Southwest Plan will also be made available to him at the same time.

If you have any questions, please contact me on 275-8678.

Sincerely yours,

Craig A. Simmons
Senior Associate Director

The **Chairman.** Obviously that was an effort to look at the question of was the bidding fair, was it proper, was it done in an orderly fashion, how were the selections made and then, of course, the actual financial aspects and the soundness of the transactions that were executed.

Later in the month of December, as the chairman designate of this committee, I also asked the GAO to conduct an in-depth review of the transactions approved by the Bank Board during the month of December. At the time I was very troubled about what I was reading in the newspaper regarding the haste in which many of these deals were being considered. Obviously, there were changes in the tax law that were coming at the end of the year, but also, the question of how the bidding process was working, was everyone getting the same treatment, and how were the decisions being made.

Secretary Brady, when he testified earlier before this committee, acknowledged that he and I had had a conversation very late in the year where I called him to express my concern about what appeared to be the pattern of some of the deal-making. And he, I think the record will show, in his responses to our committee had some of the same concerns but decided upon reflection that he really was powerless to act in that kind of a situation, despite whatever misgivings he may have had.

I then asked the GAO to take a look at every single deal that was done in the month of December to try to understand precisely how they were done so that we could have a full and clear sense for exactly what took place.

This hearing is a follow-up to that inquiry. Many people have argued that the Bank Board did the best that it could have done under the circumstances. Others have been highly critical.

The Mid-America Institute Task Force on the Thrift Crisis, an independent study commissioned by the Bank Board itself, found in its March 3 report just released that "the costs borne by the Government in assisted acquisitions may be substantially higher than that estimated by the FSLIC" per the Mid-America Institute Task Force on the Thrift Crisis.

That group also concluded:

> FLSIC may not have been compensated for tax benefits to acquirers except for a single deal involving the largest tax benefits.

The report goes on as follows:

> There are indications that FSLIC may have traded off other forms of assistance in order to obtain rebates of tax benefits. From a consolidated Government perspective, this represents a net cost since tax benefit rebates simply represent a transfer from one Government agency to another, again per the Mid-America Institute Task Force on the Thrift Crisis.

So clearly the final verdict is not yet in with respect to the wisdom and the soundness of a number of last year's FSLIC-assisted deals.

I want to cite again in today's hearing one instance of a highly publicized deal that, if the stories I have been told are accurate, evolved because the tax counsel of an individual came to that individual and said:

> Look, you've got a serious tax problem for the year 1988. That's the bad news. The good news is,

as the story is related,

> That we have found a way to solve it. And the way to solve it is to go into the savings and loan business. And that by going into the savings and loan business and picking up a very substantial tax write-off, that can be used to be set against the other activities in completely unrelated areas and therefore is a very good financial deal.

As some of these deals have been reconstructed in newspaper stories, it looks as if in cases where the tax benefits were the driving motivation for the deal, where people came into the savings and loan business who had never been in it before and were not showing at least in any discernible way any great interest in wanting to be in the savings and loan business, that the economics of those deals worked in such a way that very often they got their investment back almost immediately, within a very short period of time, because of the immediate value of the tax credits which of course were not even calculated in terms of the way the cost of these deals were presented to the public.

I find that very troubling, and I make no bones about it. That's why I asked for the audit, and I want to make sure that we persist in the audit until we have every single fact we need. And if there's an assertion made by anybody after these deals are done and a matter of public record that they're done and the documents are signed that we can't have access to the information I want to know why and where and what the circumstances are because I find that very difficult to find plausible. And there's some indication that there may be a problem in that area. I hope there is not. But if there is, I intend to solve it.

So a primary focus of this hearing today is to determine what modifications, if any, should be made in the Government's future bidding and selection process and the extent, if at all, that any of these transactions should be subject to further scrutiny by the Government and then there's a collateral question that's been raised by Mr. Seidman and others, and that is, might there even be an avenue open to us to consider renegotiating some of these deals in the future. That gets very difficult from the legal point of view to see if ways can be found to reduce the cost to the Government and to the American taxpayers.

With that, let me yield to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

Today the GAO testifies about last year's FSLIC deals focusing on the Southwest plan. Based on your earlier testimony, it's certainly not surprising that you are very critical of FSLIC's actions.

Let me make three general comments. First, your testimony makes absolutely no mention of FSLIC's cash shortage or other limitations on its ability to resolve cases last year. In other words, there's no background setting of the environment in which these deals were made. And I think that ignores some very real world complaints—constraints and complaints.

I don't want to be misunderstood. I want to be very careful, at least try to be, in what I'm going to say because I don't doubt at all that it is easy for any of us to go back and criticize some of these deals. I think we will find out that some of us will say, including me, that if I had been there I would not have done that.

But it also reminds me of my own pilot experience, and in particular one flight examiner, who was the toughest, most critical, most perfectionist flight examiner, who would sit over in that right seat, but who couldn't fly the airplane himself. He never could. I don't know how he passed the checkoffs by himself. Or it reminds me of critics who go to a play and say it was lousy when I happen to think it was good. Maybe that makes me the dumb one—lack of culture. I don't know.

My point is, that it is very easy to sit in the catbird seat, and it's GAO's job to do that. I understand that. But I guess I would like to have put some of my colleagues at GAO in these same circumstances—without the benefit of foresight and with the lack of FSLIC recap, with all of the constraints that were placed on it, the lack of money, and faced with all of these failing thrifts—and I'd like to see how they would have handled the situation.

I suppose there would be differences. I'm sure that if I had been there there would have been a difference in the way some of the deals were handled. But overall, I would expect that generally everybody would be critical of any actions that were taken. That's the point that I am trying to make. I'm not saying that these were the best deals in the world. It's easy to say that they did the best under the circumstances. I don't know whether that's true or not. I'm just saying that there were some very difficult circumstances, with no help from a previous administration, no help from a Congress, and under those circumstances I wish we would look at this in light of what was taking place at the time and recognize how easy it is to sit in the catbird seat. And we are experts at that. Oh, if there is anybody in this country, forgetting check pilots, forgetting the critics, forgetting the GAO, if there's any group of self-righteous know-it-alls in the whole world, it's 535 Senators and Congressmen who are in a legislative body with no responsibility for our actions, except to our constituents when we run for reelection. We can say anything, we can do anything, and sit back knowing that we've got the cover of the whole Congress to blame it on, just like I can. I can sit here and say, boy, if the Congress had only listened to me back in 1986. Those crazy people. If the House of Representatives had gone along with that FSLIC recap, we wouldn't be sitting here today. We are the original cop-out artists, being able to hide in our massive 535 body.

So I wish we would look at that in this context, recognizing that mistakes have been made, recognizing that some of these deals probably shouldn't have been made, could have been made better than they were, and those of us, if we had been there, obviously think that we would have done it better with what we know now. But I just wish, Mr. Chairman, that we would look at it in that context.

Second, recognizing that it seems to me the whole purpose of this exercise is to determine what should be done in the future about last year's deals, your suggestion is that the Resolution Trust Corporation established under the administration's bill should be required to review the 1988 deals and take whatever steps are necessary to save money. Well, I believe the bill already does that since it requires that the RTC—and I quote—"shall restructure where savings would be realized therefrom." It seems to me the bill already does that. It says take a look at them. If we can save the taxpayers' money, then save money—those are the words—where savings would be realized, restructure.

I think we all agree that that should be done. My point is that there may be some problems with last year's deals but the administration is addressing that head-on. When the FDIC gets the resources that were missing last year, of course it should take action to achieve savings. In fact, last year's deals were specifically structured in that way to permit review and these actions to take place.

Finally, FSLIC and the Bank Board will no doubt disagree with many of your conclusions, but they are not here to respond. So I would hope the record could be kept open, Mr. Chairman, and give the Bank Board an opportunity to respond in writing to this testimony so at least we can hear their side of the case.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Bryan.

OPENING STATEMENT OF SENATOR BRYAN

Senator BRYAN. Thank you very much, Mr. Chairman.

I, too, have been concerned about the manner in which these acquisitions occurred. The more I hear, the less I like it. Clearly in retrospect it would appear that FSLIC was operating with lack of an adequate information data base in making some of these assessments and that ultimately, because whichever plan emerges from this Congress, the taxpayers are going to be the deep pocket, that the American taxpayers have been poorly served.

So I would be very much interested in hearing your testimony in terms of what we can do, if anything, to unravel some of these transactions which clearly were not in the best interest of the American public and with a prospective look at this thing in terms of what we need to incorporate by way of additions in this legislation that we are considering so that we don't have to revisit this problem in the future.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Bryan.

Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you, Mr. Chairman.

I am happy to see Comptroller General Bowsher here to testify about the Bank Board's December deals. I'm certainly interested in his comments on this subject, but I also want the opportunity to explore with him and get his ideas on just how much the thrift industry can afford to pay, a line of questioning I've been pursuing with other witnesses.

The reason I'm interested in this is not because I want to get the savings and loan industry off the hook, but rather, I want that industry to pay as much as possible so that we can minimize the taxpayer contribution to the bailout. Healthy thrifts will realize tremendous benefits from a recapitalized insurance fund and a new sticker on the door, whatever that sticker may say, and it's appropriate to make them pay as much of the share of reestablishing the risk insurance basis from which they benefit.

That being said, there's a point beyond which it is no longer practical to exact more from the industry because they won't be able to pay it and we may force viable institutions into insolvency. I'm interested in trying to determine where that tipping point is. What is the maximum amount we can extract from the thrift industry without finishing them off?

We need to take blood from the industry, but we need a healthy patient to maximize that blood because blood we don't draw from the industry is going to bleed from the Treasury. My interest is in pursuing with you and others how much blood we can withdraw from the patient without killing him.

Thank you, Mr. Chairman.

The **CHAIRMAN**. Thank you very much, Senator Bond.

Senator Cranston.

Senator **CRANSTON**. Thank you very much. I have no opening comments. I welcome you and look forward to your testimony.

The **CHAIRMAN**. Thank you.

Senator Pressler.

Senator **PRESSLER**. Thank you, Mr. Chairman.

I join in the remarks to put as light a burden on the taxpayer as possible. I fear that it's going to be a heavy one. I look forward to your elaborating on page 11 of your testimony which I've looked at how they conducted a blind process which really may have decreased the likelihood of attracting the largest pool of qualified prospective bidders.

But in any event, I think this is a very important piece of testimony and look forward to your elaborating on it.

The **CHAIRMAN**. Thank you, Senator Pressler.

Senator Graham.

OPENING STATEMENT OF SENATOR GRAHAM

Senator **GRAHAM**. Thank you, Mr. Chairman.

Mr. Chairman, late last summer my office became aware of the problems acquirers were encountering with the Federal Home Loan Bank Board's process for selling insolvent thrift institutions.

After reviewing the process with the Home Loan Bank Board, my initial concern deepened. It was unclear whether any formal set process existed or whether the Bank Board used a different tack with each institution it sold.

From an acquirer's perspective, it was very difficult to negotiate in good faith with the Bank Board and its various departments. At every level the acquirer encountered different negotiation requests. The different Bank Board departments and FSLIC entities did not appear to talk to each other and one hand spent a great deal of time untying the transactions the other hand had knotted.

Therefore, I joined with the chairman and some of my colleagues in October to ask the GAO to review five transactions to determine whether they were fairly conducted, including the bidding process, whether they took care of the taxpayers' interest, particularly in light of the tax advantages provided, and whether the new institutions were strong enough to avoid failing again.

I look forward to Mr. Bowsher's testimony today to help us answer these questions.

The **Chairman**. Thank you very much, Senator Graham.

I have statements from Senators Cranston and Dixon to be inserted in the record.

STATEMENT OF SENATOR CRANSTON

Senator **Cranston**. I share concerns about the cost of these deals and whether the cost of liquidations will be cheaper than some of the merger deals. I have sent a letter to Chairman Riegle requesting GAO to compare the cost of the liquidation at the FDIC to the cost of liquidation by the FSLIC, particularly in the southwest.

The committee needs to know FDIC's track record in cost effectiveness before we transfer all of this authority to them. I would like this letter to go into the record.

Thank you, Mr. Chairman.

DONALD W. RIEGLE, JR., MICHIGAN, CHAIRMAN

ALAN CRANSTON, CALIFORNIA
PAUL S. SARBANES, MARYLAND
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KEVIN C. GOTTLIEB, STAFF DIRECTOR
LAMAR SMITH, REPUBLICAN STAFF DIRECTOR AND ECONOMIST

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

March 3, 1989

The Honorable Donald Riegle
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

I understand that you have requested that the General Accounting Office commence an investigation of the case resolution activities of the Federal Savings and Loan Insurance Corporation. In light of the increased involvement of the Federal Deposit Insurance Corporation contemplated in the "Financial Institutions Reform, Recovery and Enforcement Act of 1989," an identical analysis of comparable case resolution activities of the Federal Deposit Insurance Corporation should be incorporated in the study. Before the Congress enacts legislation providing $50 billion for the resolution of the Savings and Loan problem, we should ensure that the most cost effective case resolution methodology will be employed.

To assist the Committee in considering the FDIC's new role in the President's proposal, a comparison of the FDIC's case resolution methodology with particular attention being focused upon the large assisted acquisitions which have been conducted by the FDIC in the Southwest region of the United States should prove valuable if compared to the FSLIC methodology. I would like to request answers to the following specific questions in that regard:

1. List the 10 largest FDIC liquidations since 1980?

2. With regard to these 10 transactions?

   a. What was the calculated estimate for the cost of each liquidation?

b. What has the FDIC's experience been to date relative to the estimated cost of liquidation?

3. What is the average "lifetime" of a FDIC Receivership?

4. How many personnel are typically employed in a FDIC Receivership?

    a. average
    b. per dollar amount of assets?
    c. per asset?

5. What is the typical asset mix of an institution placed into FDIC Receivership?

6. What has been the historic cost recovery record of FDIC Receiverships in terms of the final price received on assets versus the original book value of those assets?

7. Taking into account all costs incurred in the operation of a federal receivership including personnel, outside consultants, legal and all other operational expenses, what has the FDIC'S historical recovery record been in receiverships since 1980, relative to the original book value of the assets at takeover?

8. Compare the strengths and weaknesses of FSLIC and FDIC assisted transactions. For example, how does the "put" option arrangement for bad assets in NCNB's FDIC Assistance Agreement compare with the capital loss coverage and yield maintenance used by the FSLIC?

9. How much of the capital contribution by NCNB can be directly or indirectly borrowed from the FDIC? At what rate? For how long? Is there an implicit subsidy compared to the cost of private capital?

10. What percentage of the tax benefits does the FDIC recapture in the NCNB transaction if one excludes the initial FDIC "hole filling," which would not normally be taxable in a non-government transaction?

11. How does the estimate of approximately $4-$5 billion of

> losses on the bad assets in the NCNB transaction compare to the FDIC's cost estimate of approximately \$1-\$2 billion?

This additional information would prove enlightening in that it would give the Banking Committee a basis for comparing banking and thrift insurance agencies cost effectiveness. This analysis could also serve as an advance warning to Congress as to whether banks might be facing the same crisis as their counterparts in a matter of time. Steps could then be initiated to solve these problems before they escalate.

If it is not possible to get this request into the GAO study, would you have GAO supply the answers to these questions before floor activity on S. 413. I believe we need to know if FDIC can appropriately handle the magnitude of the job we are imposing on them and these questions are designed to elicit information in that regard.

Sincerely,

Alan Cranston

DONALD W. RIEGLE, JR., MICHIGAN, CHAIRMAN

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United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

March 16, 1989

The Honorable Charles A. Bowsher
Comptroller General of the United States
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Bowsher:

I join with Senator Cranston in requesting that GAO respond to the request detailed in the attached letter, in time for floor action on S. 413 which is anticipated to take place sometime between April 14 and 18, 1989.

Sincerely,

Don Riegle

Donald W. Riegle, Jr.
Chairman

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee commences the final week of its very intense hearings schedule on the problems of the thrift industry. I look forward to hearing the testimony of the Comptroller General of the United States, Charles Bowsher. I know the committee will benefit greatly from his counsel and advice.

The subject of today's hearing is a matter of specific concern of mine. I have previously, repeatedly criticized the 1988 year-end FSLIC-assisted sales of failed thrifts. They were plainly too expensive. The Federal Home Loan Bank Board approved some $38 billion of these deals and did not take proper account of their cost to taxpayers.

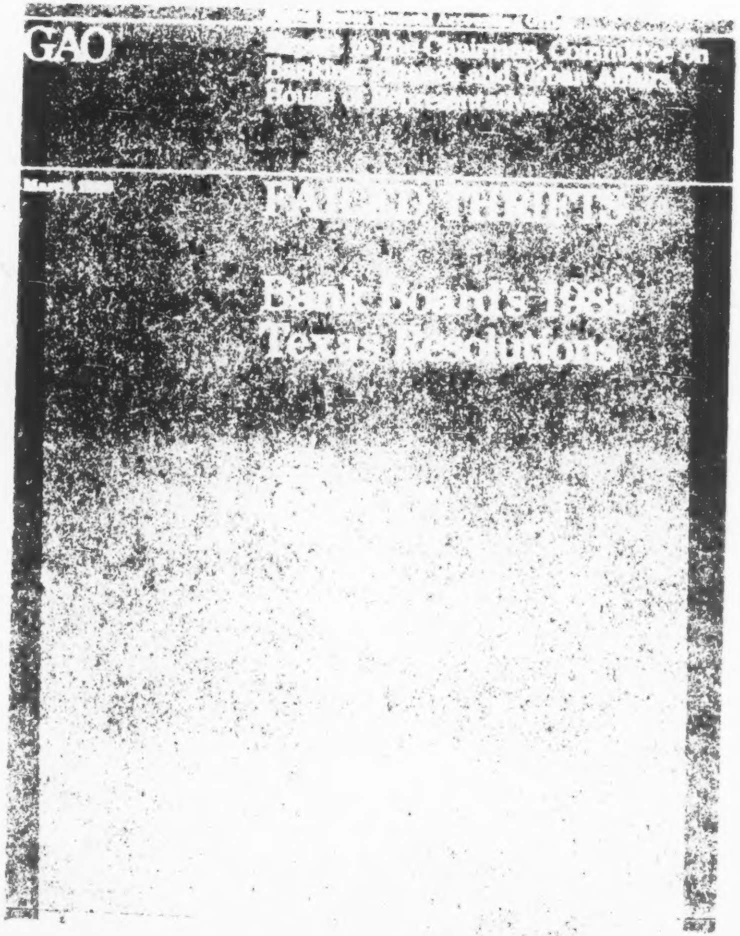
I have been a business man. I know a bad deal when I see one. But you do not need to take my word for it. Last month the Bank Board commissioned the Mid America Institute for Public Policy Research—which is based, by the way, in the great city of Chicago—to provide an indpendent, nonpartisan report, prepared by a group of academic experts, on whether the year end deals were good deals or not.

Do you know what they concluded? According to their study, FSLIC bargained away tax benefits for lower FSLIC assistance payments, even though the total cost to the Government was higher. Second, in the bulk of cases, FSLIC was not compensated for the tax benefits it transferred to acquirers. Third, the costs to the Government of assisted acquisitions may be substantially higher than FSLIC's estimates. Finally, liquidation may have been preferable to assisted acquisition in a significant number of cases.

Mr. Chairman, I request that the report of the Mid America Institute Task Force on the thrift crisis, entitled "Crises Resolution in the Thrift Industry: Beyond the December Deals," be included in the record.

I am very pleased that the General Accounting Office has also examined some of these year-end deals. As a result of these informative studies, I hope that we will be able to get these deals refinanced in order to reduce their cost.

We are asking a lot of our taxpayers in resolving the thrift problems. Let us, at least, get the best deal possible for them that we can. Thank you, Mr. Chairman.



GAO

Report to the Chairman, Committee on Banking, Finance and Urban Affairs, House of Representatives

March 1989

FAILED THRIFTS

Bank Board's 1988 Texas Resolutions

GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-232785

March 11, 1989

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking,
  Finance and Urban Affairs
House of Representatives

Dear Mr. Chairman:

This report provides our preliminary views in response to your request that we review the Federal Home Loan Bank Board's (FHLBB) 1988 resolutions of insolvent thrifts in Texas. Almost all of the resolutions were accomplished under the FHLBB's Southwest Plan in complicated assistance transactions. In 1988, FHLBB approved 15 assisted transactions in Texas involving 87 insolvent thrifts at a projected cash cost of about $44 billion.[1]

In February 1989, a moratorium on such transactions was announced following the Bush Administration's proposal for a resolution of the thrift crisis.

RESULTS IN BRIEF

A thrift industry still exists in Texas but we are concerned about its viability. Also, the ultimate cost to the government of the Texas thrift transactions is uncertain. With little cash to liquidate insolvent thrifts, the Federal Savings and Loan Insurance Corporation (FSLIC) provided a wide range of financial assistance in the form of notes and guarantees to attract acquirers to buy packages of thrifts. The long-term cost of this assistance could be more than FSLIC's estimates if

-- the assets for which FSLIC provides an operating subsidy have lesser value than the unaudited financial reports indicate, requiring increases in FSLIC subsidies, or

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[1] This includes one transaction involving eight thrifts which were merged and assisted without a final acquirer. The purpose of this transaction was to stablize and take control of these thrifts.

-- interest rates increase, making it more difficult for the thrifts to realize projected income levels and increasing the amount of FSLIC assistance needed during the assistance period.

The process used to solicit and select acquirers for the Texas thrifts was loosely structured and was administered inconsistently by the FHLBB and Dallas District Bank.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objective was to provide information on the background and current status of the Plan; describe a typical assisted transaction or "deal"; and provide our preliminary assessment of the Plan's progress in achieving its objectives, along with our concerns about the transactions. To develop this information, we (1) reviewed FHLBB's policies and procedures; (2) reviewed documents, studies, and statistics concerning the Plan, which were available at the Dallas District Bank and FHLBB; (3) interviewed a FHLBB member, the former head of FSLIC, the director of the Plan, and other FHLBB and district bank officials responsible for the Plan or transactions; and (4) reviewed statistics and other data concerning all 15 transactions completed in 1988. We also assessed eight of the transactions in detail. The eight transactions covered the resolution of 60 insolvent thrifts with total assets of about $32 billion. Our work was done in accordance with generally accepted government auditing standards.

The information provided by FHLBB and the district bank was often insufficient for us to draw firm conclusions concerning their actions or decisions. The data has not been audited and often contained inconsistencies. Additionally, we asked for information on the status of controls over the assisted transactions. The FSLIC division responsible for administering the large, complex transactions is still developing the information.

SPECIAL PLAN TO REORGANIZE THE TEXAS THRIFT INDUSTRY

On February 3, 1988, FHLBB approved the Southwest Plan, a program designed to resolve the multibillion dollar problem of insolvent thrifts, primarily in Texas. FHLBB based the Plan on its opinion that consolidating insolvent thrifts "with some combination of healthy institutions and capital infusions will produce viable thrifts. . . ." The Plan was

unusual in that all insolvent thrifts in the state were to be included in the program. The thrifts were to be grouped and sold in prearranged packages, but the make-up of the groupings would not be known to the investors until they entered the final negotiation process. As a result, the investors did not know precisely what they were bidding on. Even more importantly, neither the investor nor FSLIC determined the true value of the failed thrifts' accounts through the normal process known as due diligence before bidding on the packages. Consequently, neither FHLBB nor the investors knew the true financial state of the thrifts being merged and sold.

FHLBB did know that Texas thrifts were in serious distress. By our calculations using generally accepted accounting principles (GAAP), 125 of 279 Texas thrifts were insolvent[2] as of December 31, 1987. Nationwide, Texas thrifts represented almost 25 percent of all insolvent thrifts and held almost 34 percent ($47 billion) of insolvent thrift assets.

In implementing the Southwest Plan, FHLBB sought, among other things, to (1) retain a competitive environment and therefore preserve the basic thrift industry in Texas, (2) reduce or eliminate any duplications and redundancies in the Texas industry, (3) identify the most capable individuals to manage the new thrifts, (4) reduce expenses and control losses in problem thrift assets, (5) use FSLIC's resources efficiently; and (6) enable FSLIC to share in any future profits of the assisted institutions.

PROVISIONS OF A TYPICAL ASSISTANCE TRANSACTION

Common features of the 15 Texas transactions were FSLIC's agreements to contribute a promissory note for the negative tangible net worth[3] of the insolvent thrifts being sold, guarantee the value of and a certain return on the most risky of the thrifts' assets (covered assets), and pay legal and other expenses arising from the acquisition. (See app. I for details on the 15 transactions.)

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[2] A thrift is considered insolvent when its net worth is less than zero. The FHLBB can place a thrift into receivership or conservatorship when its capital, measured according to FHLBB regulations, is less than zero.

The interest rate on the FSLIC notes and return guarantees on covered assets were variable, based on the average cost of funds for all Texas thrifts plus a premium expressed in basis points. The return guarantee decreased during the agreement period. For example, in one transaction the guarantee premium started at 250 basis points and declined to 150 basis points in the ninth and tenth years. The premium is meant to defray the thrift's costs associated with the covered assets plus provide some profit. FSLIC can usually prepay the notes with no penalty and can also buy the covered assets at book value.

The acquirer was required to invest new capital in 13 of the 15 transactions. In all but one transaction, FHLBB obtained the right to purchase an equity position in the new thrift and will receive some or all of the acquirer's tax savings arising from the transaction.

CONCERNS ABOUT TEXAS TRANSACTIONS

Our assessment of how well the objectives have been achieved, based on available data, and our related concerns follow.

Retain a Competitive Environment and Preserve the Thrift Industry

There is still a thrift industry in Texas, but we are concerned about the viability of the new thrifts. These thrifts are thinly capitalized and will continue for some time to be dependent on FSLIC assistance.

Many Thrift Assets Are in FSLIC-Assisted Thrifts

Many Texas thrift assets are now concentrated in a small number of very large thrifts assisted by FSLIC. The 15 new thrifts created by the 1988 transactions purchased 42 percent of all Texas thrift assets as of December 31, 1987. These thrifts are now and, according to FSLIC's analyses, will for some time be dependent on FSLIC assistance for their viability. During the first 5 years of operations, FSLIC assistance will make up more than half of the projected gross income of seven of the eight thrifts we reviewed in detail. In the other thrift, assistance will make up at least 43 percent of total projected income. By the fifth year, FSLIC assistance will range between 45 and 80 percent of each thrift's total projected income. These income projections are based on optimistic business assumptions. Also, FSLIC maintains considerable operational control and has a long-term equity interest in the new institutions.

Assisted Thrifts Have Competitive Advantages Over Unassisted Institutions

The assisted thrifts have a strong degree of protection against adverse economic circumstances because they have little or no risk of losing the value or return on covered assets. For example, a further decline in real estate values would not affect covered assets because of FSLIC's indemnification against loss of principal. FSLIC and two of the eight thrifts we reviewed in detail share in losses when the assets are sold for less than half of book value. These provisions, however, expire, for one thrift after the third year.

Also, a rise in market interest rates will not affect the income that assisted thrifts derive from covered assets because FSLIC guarantees that the return on covered Texas thrifts' assets will exceed the average cost of Texas funds, whatever that cost may be. A rise also will not affect interest income from FSLIC notes because interest rates on the notes will also vary with the average cost of funds.

Capitalization and Profitability of the New Thrifts Are Not Strong

Once it selected the preferred acquirer of a thrift group, FSLIC determined the viability of the new institution by analyzing projected capital and profit levels. The capital measure used by FSLIC was net worth to total liabilities, or capital ratio. Profitability was based on return on assets.

To measure the relative strength of the new Texas institutions created during 1988, we compared them to other healthy U.S. thrifts in terms of capital and profitability. Because 12 of the 15 new Texas thrifts have assets of over $1 billion, we compared them to the 100 largest thrifts in the nation as of September 30, 1988, as measured by total assets. Nine of the 100 largest U.S. thrifts had a negative GAAP net worth as of September 30, 1988, and were excluded from the capital ratio comparison. Thirty unprofitable ones were excluded from the profitability comparison.

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[3] Tangible net worth in the transactions was the owners' capital less goodwill further adjusted by adding the amount of reserves for losses.

In general, the largest U.S. thrifts had higher capital ratios than the new Texas thrifts. FSLIC's projected capital ratios of the new thrifts ranged from 1.3 percent to 5.0 percent, and the median ratio was 2.2 percent in the first year. By contrast, the median ratio for the largest U.S. thrifts was 4.5 percent. We also considered the projected capital ratios of the Texas thrifts after 5 years of operations.[4] The median ratio was 4 percent, which is still below the 4.5 percent median for the largest solvent U.S. thrifts. In other words, the mergers completed in Texas during 1988 left the new thrifts thinly capitalized from the outset relative to the industry's largest solvent thrifts.

The above comparison of projected capital levels ignores the fact that capital requirements for most non-assisted thrifts are expected to increase significantly over the next 5 years. The thrifts in these transactions, however, are to a large extent, sheltered from these increasing requirements by capital forbearance on covered assets. Furthermore, the assets on which capital levels are based result substantially from the assistance agreements themselves, rather than from the acquirer's contribution. Capital, or the owner's stake, serves as an incentive to prudent management. With the limited capital in these institutions it is unclear whether adequate and proper incentives exist.

FSLIC's projections of the thrifts' profitability assumed moderately rising interest rates.[5] The projections showed annual returns on assets improving over a 5-year period to a point where they were about equal to the returns generated by

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[4] The 5-year projections have not been adjusted downward to reflect tax benefits paid to FSLIC.

[5] FSLIC assumed interest rates would increase 100 to 150 basis points over 10 years, with most of the increase occurring during the first 3 years.

the largest profitable U.S. thrifts in the third quarter of 1988.[6]

Specifically, in the fifth year after the assisted mergers, the projected returns on assets ranged from negative 14 basis points to 197 basis points, with a median of 52 basis points. Of the 100 largest U.S. thrifts as of September 30, 1988, 70 were profitable in the third quarter. Annualized, the median return on investment for these U.S. thrifts was 42 basis points, slightly less than the level projected for the Texas thrifts after 5 years of projected generally improving performance.

Reduce or Eliminate Costly Duplications Such as Redundant Branch Operations

This objective has been partially achieved. A Bank Board member told us that 239 branches out of 1,821 in Texas as of December 31, 1987, were scheduled to be closed by March 31, 1989, and that this goal had been 60 percent accomplished by mid-January. According to a February 3, 1989, FSLIC interim report, 167 branches had been closed and 100 were scheduled for closure. The report said that the ratio of operating expenses to total assets was reduced by 33 percent in the first five 1988 transactions.

Identify the Most Capable Management to Implement the Plan

While FHLBB established processes for evaluating prospective management, we cannot assess whether the "most capable" management was attracted. The FHLBB and the Dallas District Bank reviewed examination reports as well as other documents and met with the management of thrifts to assess them. Prospective acquirers which were not affiliated with financial institutions were asked to provide financial and other background information. The FHLBB also reported that they checked the names of key managers against records of the Federal Bureau of Investigation.

We could not assess the full extent to which the FHLBB followed its prescribed processes because it did not always document the basis of its decisions. FHLBB allowed much of the senior management team from one insolvent thrift in the package (together with a new president) to manage the new entity. These managers were in charge when district bank officials found that the insolvent thrift had inaccurately reported its assets. In another transaction, FHLBB signed one agreement when the new management had no known experience in operating thrifts.

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[6] The 5-year projections have not been adjusted downward to reflect FSLIC's share of tax benefits.

Provide a Mechanism for Reducing the Expenses and Controlling Losses in Troubled Assets

FHLBB has attempted to provide the means to reduce expenses and control losses in troubled assets by requiring business plans for the management of each large covered asset. This is an important feature of the transactions, but we are concerned whether this approach will be effective and whether the highly detailed nature of the required plans will prove an efficient tool for both thrift management and regulators.

Adequate Incentives for Aggressive Disposition of Troubled Assets May Be Lacking

While the thrifts are indemnified against loss from the sale of covered assets, the FSLIC yield guarantees may be incentives not to sell assets. This is because the interest rates paid by FSLIC on covered assets may be higher than the after-tax yield the thrift could obtain by reinvesting the proceeds if these assets were sold.

Though the guaranteed yield declines over the life of the agreements, there is no certainty the reductions themselves provide sufficient incentive for acquirers to properly manage and dispose of property. The acquirers' plans to sell an asset could be influenced by such factors as

-- any gain or loss sharing agreement with FSLIC;

-- the amount of profit included in the yield guarantee compared to the expected net profit after tax from reinvesting the proceeds from the sale; and

-- the best timing for the use of the tax benefits from the capital loss deduction.

Provisions in the transaction agreements give FSLIC some control over the acquirer's management and disposition of assets. A typical provision obligates the acquirer to use its best efforts to manage and liquidate assets in a manner that will minimize losses. Also, FSLIC may require an acquirer to sell a covered asset and may have the right to approve the sale of any covered asset. The effectiveness of such controls, however, is dependent on the effectiveness of FSLIC's monitoring, about which we have concerns.

The administration has already taken a positive step by combining FSLIC's resources with those of FDIC and placing most activities more directly under FDIC's direction. Even before that positive move, the examination and supervisory staff had increased in numbers and, according to FHLBB, in expertise. The Dallas Bank established a special unit of supervisors and analysts to monitor Plan institutions. The Dallas Bank plans to place full-time, "resident" examiners at the larger institutions. Nine FSLIC staff are now based at the Dallas Bank to review and approve business plans for covered assets as well as related payments for yield maintenance and asset sales. The Dallas Bank will also have to monitor and control the amounts of FSLIC notes and the thrifts' rights to receive FSLIC payments, both of which are accepted as collateral for advances by the Dallas Bank.

Despite these new arrangements, we have fundamental concerns about the effectiveness of the FHLBB's supervision because of its conflicting roles as both promoter and regulator of the thrift industry. We have recommended that regulatory functions such as supervision and examination of the industry be separated from the FHLBB, which is influenced by the industry. The staff responsible for examination and supervision should not be accountable to FHLBB.

Provide for the Efficient Use of FSLIC Resources in Resolving Problems

We cannot say if FSLIC used its limited resources most efficiently in resolving the problem thrifts. While the basic premise of the Plan did not preclude liquidating any of the insolvent thrifts, FSLIC's poor financial condition precluded major liquidations--an option that may have been more economical had substantial cash been available to FSLIC. All institutions, no matter how poor their financial condition, were assigned to a group to be marketed. It is possible that FSLIC may have been able to make better deals without including some of the most insolvent thrifts.

Under the transactions, FSLIC has the option of prepaying its notes without penalty or buying covered assets at book value if cash becomes available. Whether these actions would reduce overall FSLIC costs would depend on such factors as FSLIC's borrowing costs and asset management capabilities as well as the viability of the affected thrifts after these transactions.

Solicitation and Selection Process

FHLBB's solicitation of interested acquirers may not have enabled it to attract the largest pool of qualified prospective acquirers. To market the Texas thrifts, FHLBB sought "statements of interest" from Texas thrifts and others deemed to be financially and managerially suitable as acquirers and from other potential acquirers. Most prospective acquirers, however, were not told which thrifts were being marketed, how FSLIC planned to combine them in groups, or the thrifts' current financial condition. This "blind" process may have discouraged prospective investors from pursuing acquisitions. Also, it meant that most investors proposed buying only some portion of the prearranged groups and FHLBB, therefore, evaluated their proposals on the basis of incomplete information. Unless the potential investors passed this initial screening, they had no opportunity to refine their proposal on the basis of information subsequently provided by FHLBB, such as the identities of the thrifts.

Monitoring Will Be difficult

The complexity and uniqueness of each merger makes oversight very difficult. The previous discussion of typical components of a consolidation agreement provides some insight into their complexity. Some standard materials are being required to monitor each new institution. For example, a separate business plan proposing the management, marketing, and ultimate disposition of each significant covered asset is required, with financial and operating details being frequently (as often as monthly) submitted for approval.

However, because requirements vary depending on the agreement, FSLIC and district bank monitoring must be individually tailored for each agreement. For example, the agreements require an initial report, including budgeted income and expenses for each asset, followed by regular updates. Periodic reports related to the institutions' use of specific regulatory forbearances are also required. In addition, FSLIC must approve asset schedules, asset summaries, collection plans for large assets, asset budget summaries, asset sales requests, and asset term sheets if the thrift is providing the financing. FSLIC must approve plans and budgets for litigation. It must review itemized charges for yield maintenance and capital losses submitted quarterly for payment.

The new institutions are combinations of up to 15 failed thrifts with combined assets of up to $12 billion. The complexity of the work is increased by the poor condition of the books of many of these institutions, making accurate audits difficult and time consuming.

Designate Shares of the Future Profits of Assisted Institutions for FSLIC

The transaction agreements generally provide FSLIC an equity position in 14 of the 15 new institutions as well as its participation in certain tax benefits. However, FSLIC's projections for the new thrifts' profits are modest. FSLIC's cost analyses estimated the value of all its returns from profit sharing and stock warrants at about $400 million. In February 1989, FSLIC estimated its share of tax benefits at about $2.2 billion for 14 of the 15 transactions.

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As arranged with your office, we will send copies of this report when it is made public to the Senate Committee on Banking, Housing and Urban Affairs; the Federal Home Loan

Bank Board; the Federal Reserve; the Department of the Treasury; the Federal Deposit Insurance Corporation; and other interested parties.

Sincerely yours,

Richard L. Fogel

Richard L. Fogel
Assistant Comptroller General

The CHAIRMAN. Let me now introduce our witnesses today. Our lead witness is Charles Bowsher, who is the Comptroller General of the United States, U.S. General Accounting Office, and he is accompanied by Mr. Richard Fogel, who is the Assistant Comptroller General; and also by Mr. Frederick Wolf, also an Assistant Comptroller General. We are delighted to have you back with us this morning. This is a very important piece of work that you have done at our request and we are very anxious to hear your observations.

STATEMENT OF CHARLES A. BOWSHER, COMPTROLLER GENERAL OF THE UNITED STATES, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY RICHARD L. FOGEL, ASSISTANT COMPTROLLER GENERAL, GENERAL GOVERNMENT DIVISION; AND FREDERICK D. WOLF, ASSISTANT COMPTROLLER GENERAL, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION

Mr. BOWSHER. Thank you very much, Mr. Chairman and members of the committee.

We are pleased to be here today and what I'd like to do is just read the first three pages of our testimony, which is a good summary, and then go to questions. If the full statement could be put in the record we would appreciate it.

The CHAIRMAN. We will make the full statement a part of the record and we would be happy to have your summary.

Mr. BOWSHER. Thank you.

Today we are here to discuss the Federal Savings and Loan Corporation's assisted sales of failed thrifts approved by the Federal Home Loan Bank Board in 1988. This work was done in response to the October 20, 1988, request from you and five other Senators to select and assess five transactions and your December 30 request concerning the December 1988 transactions.

During 1988, the Bank Board acted on some 220 thrifts at an estimated present value cost to FSLIC of about $37 billion. Of this total, 179 thrifts were sold to acquirers in 86 transactions at a present value cost of $28.4 billion. Seventy-five of the 179 thrifts were sold in 34 transactions in December. We have reviewed 12 transactions—5 that occurred before December, the 5 Southwest plan December transactions, and the 2 largest non-Southwest plan transactions. Of the 12, 8 were Southwest plan transactions.

Our analysis of these transactions has reinforced the views we have expressed previously to your committee and increased our concerns about the appropriateness of the deals.

The costs to FSLIC will be higher than estimated if the guaranteed assets do not have the projected values. That is that all of these numbers that we are seeing now, including the note that has to be given for the difference between assets and liabilities, are very preliminary. Audits have to be done on practically all of these deals and the audits are just getting started on most of them. None of them have been completed. The ones that are near completion give some indication that the amount of the note will have to be increased by quite a substantial margin.

The other thing that can drive costs up of course is the interest rate increases.

Now, on tax benefits. Our estimate of the tax benefits for the 1988 transactions is between $7 billion and $8 billion in present value terms—this is compared to $5.7 that the Federal Home Loan Bank Board had estimated. I might also point out that we did this review on the tax benefits with the Treasury people and also the Joint Tax Committee staff. So this is an estimate that all three have come into agreement on. That puts it about 20 to 40 percent higher than FSLIC estimated. FSLIC did not explicitly take these benefits into account, nor were they legally required to, when they chose to merge the institutions rather than liquidate them.

If the full cost of the deals to the Federal Government is considered, our analysis suggests that liquidation could have been cheaper in as many as a third of the transactions we reviewed.

It appears that tax benefits will enable some purchasers to recover their capital investments very quickly. For the 12 transactions that we examined, we estimate the investment in as many as three-fourths can be recaptured in an average of 3 years, ranging between 1 and 5 years.

The new thrifts are thinly capitalized, a situation which historically provides incentives to take risks.

There is a lack of sufficient incentives for the new thrifts to effectively manage and liquidate the guaranteed assets to minimize FSLIC assistance costs.

The selection process was loosely structured and administered inconsistently. The process may have decreased the pool of prospective bidders, inhibited FSLIC's ability to evaluate the acceptability of proposals, and resulted in a less efficient use of FSLIC resources.

And we have put into this statement one example of how the deals were done. What it was, was actually getting a lot of people to come in to bid and then narrowing it down to a few, and then lots of times the few would disappear and you would get down to one. In this case, actually the one was determined to be insolvent. When he went out to try to get an investor that would put more money in, the investor insisted on an audit and so then what happened was they moved that thrift into the insolvent group and they sold it to the investor without ever going back to get additional bids from other groups. So this is an example of how some of the deals were done and it raises some questions. There's just no question.

We have said earlier in our testimony that the new thrifts have competitive advantages over unassisted thrifts, and that's because of the guaranteed return on assets and asset book value and reimbursements for various expenses.

FSLIC and the Bank Board have included very complex control features in the agreements. But we question whether FSLIC can administer these extensive monitoring provisions with present resources.

Bill Seidman pointed out in the testimony down in San Antonio that the Government will be actually robbed, he says, if we don't monitor these deals very carefully and they are complicated and we are going to need to have the resources to do it well, and I strongly second that point.

So based on all of these points, we believe the deals should be carefully reexamined. The administration's bill authorizes the Resolution Trust Corporation to make such a review, and the reason we put it in this statement, Senator Garn, was that it doesn't require them to. It authorizes it, but we are recommending that they do it.

Options that could be used to reduce the Government's costs include prepayment of negative net worth notes and purchase of guaranteed assets. Of course, the Government's ability to exercise such options depends on the availability of adequate funding, which of course goes back to the legislative proposal.

Mr. Chairman, I think that summarizes our main points. We would be pleased to answer any questions.

[The complete prepared statement of Charles A. Bowsher follows:]

SUMMARY OF STATEMENT BY
CHARLES A. BOWSHER
COMPTROLLER GENERAL
OF THE UNITED STATES

GAO's analysis of Federal Home Loan Bank Board 1988 deals to resolve failed thrifts has intensified GAO's earlier reservations about the appropriateness of the deals.

-- The way purchasers for the Texas thrifts were solicited and selected may not have enabled FSLIC to attract the largest pool of qualified prospective acquirers and may not have resulted in the best terms possible.

-- The costs to FSLIC will be higher than estimated if the guaranteed assets do not have the projected values or if interest rates increase. Also, the new thrifts lack incentives to most effectively manage and liquidate the guaranteed assets.

-- GAO's estimate of the potential tax benefits to the acquirers for the 1988 transactions is between $7 billion and $8 billion on a present value basis. This is between about 20 and 40 percent higher than what FSLIC estimated. Moreover, FSLIC did not adequately take these benefits into account when negotiating the agreements. In deciding whether merger or liquidation was least costly, FSLIC was not legally required to consider the cost of the tax benefits. But GAO's analysis suggests that, if the full cost of the deals to the Government is considered, liquidation would have been cheaper in as many as a third of the 12 transactions GAO reviewed.

-- Some purchasers will recover their capital investments very quickly because of the tax benefits--in an average of 3 years in 9 of the transactions. The range is from 1 to 5 years. The new thrifts are also thinly capitalized, a situation which has historically provided incentives to take risks.

-- GAO questions whether FSLIC presently has the resources for the extensive monitoring these complex deals require.

GAO believes the Government should review the deals to take advantage of provisions to reduce its cost. But this action, which includes buying notes and assets, is dependent on the Government having sufficient funds.

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss the Federal Savings and Loan Insurance Corporation (FSLIC)-assisted sales of failed thrifts approved by the Federal Home Loan Bank Board in 1988. This work was done in response to the October 20, 1988, request from you and five other Senators to select and assess five transactions and your December 30, 1988, request concerning the December 1988 transactions.

During 1988, the Bank Board acted on some 220 thrifts at an estimated present value cost to FSLIC of about $37 billion. Of this total, 179 thrifts were sold to acquirers in 86 transactions at a present value cost of $28.4 billion. Seventy-five of the 179 thrifts were sold in 34 transactions in December. We reviewed 12 transactions--5 that occurred before December, the 5 Southwest Plan December transactions, and the 2 largest non-Southwest Plan transactions. Of the 12, 8 were Southwest Plan transactions. (Table 1.)

Our analysis of these transactions has reinforced the views we have expressed previously to your Committee and increased our concerns about the appropriateness of the deals.

-- The costs to FSLIC will be higher than estimated if the guaranteed assets do not have the projected values or if interest rates increase.

- -- Our estimate of the tax benefits for the 1988 transactions is between $7 billion and $8 billion in present value terms--about 20 to 40 percent higher than FSLIC estimated. FSLIC did not explicitly take these benefits into account, nor were they legally required to, when they chose to merge institutions rather than liquidate them.

- -- If the full cost of the deals to the federal government is considered, our analysis suggests that liquidation could have been cheaper in as many as a third of the transactions we reviewed.

- -- It appears that tax benefits will enable some purchasers to recover their capital investments very quickly. For the 12 transactions examined, we estimate the investment in as many as three-fourths can be recaptured in an average of 3 years, ranging between 1 and 5 years.

- -- The new thrifts are thinly capitalized, a situation which historically provides incentives to take risks.

- -- There is a lack of sufficient incentives for the new thrifts to effectively manage and liquidate the guaranteed assets to minimize FSLIC assistance costs.

- -- The selection process was loosely structured and administered inconsistently. The process may have decreased the pool of prospective bidders, inhibited FSLIC's ability to evaluate the acceptability of proposals, and resulted in a less efficient use of FSLIC resources.

- -- The new thrifts have competitive advantages over unassisted thrifts.

- -- FSLIC and the Bank Board have included complex control features in the agreements. But we question whether FSLIC can administer these extensive monitoring provisions with present resources.

Based on these points, we believe the deals should be carefully reexamined. The administration's bill authorizes the Resolution Trust Corporation to make such a review. Options that would be used to reduce the government's costs include prepayment of negative net worth notes and purchase of guaranteed assets. Of course, the government's ability to exercise such options depends on the availability of adequate funding.

TRANSACTION COSTS

We are concerned that the costs of the 1988 transactions may exceed the FSLIC estimates--about $37 billion in present value terms or about $62 billion on a cash basis.

-- The financial condition of the failed thrifts is not known. Initial audits are to be conducted, for example, at the new thrifts in Texas to determine, among other things, the amount of the negative net worth note. While no such audit has yet been approved, we understand that for one thrift the note may be increased by about two-thirds.

-- FSLIC assumed, in making cost estimates for the Texas transactions we examined, that interest rates would only rise 1 to 1 1/2 percent over the 10 year period of the Southwest Plan assistance agreements. If interest rates increase more, the costs to FSLIC will rise.

TAX BENEFITS

The total cost to the government will probably be higher than FSLIC has estimated because of the tax benefits to the acquirers.

Special provisions in the Internal Revenue Code grant substantial tax benefits to acquirers of insolvent thrifts. FSLIC often shares in these benefits. One provision makes the sale of insolvent thrifts eligible for tax-free treatment as a reorganization without meeting all the usual requirements. Qualification as a tax-free reorganization and other special

provisions allow the acquired thrift's preagreement net operating losses (NOLs) to be deducted against the future income of the new thrift.

The rules also enable the new thrift to carry over the full value of assets from the acquired thrift. Because this value is generally higher than the fair market value, there is a loss when the assets are sold. This "built-in" loss is deductible against the new thrift's income and may also be used to offset income of a holding company which owns the thrift.

Other special provisions provide that FSLIC assistance is excluded from taxable income and is not reflected in the tax basis of the new thrift's assets. The principal types of FSLIC assistance payments are: guaranteed returns on assets; interest on FSLIC notes; negative net worth notes; and reimbursements for expenses and built-in losses. The use of these benefits was extended for transactions entered into in calendar year 1989, but reduced by 50 percent.

FSLIC provided us with projections of the tax consequences of the 1988 transactions and the basis on which they made these calculations on February 9, 1989. They showed total tax benefits of $5.7 billion when calculated in present value terms.

For the 86 transactions resolved in 1988, we estimate the tax benefits, on a present value basis, to be between $7 billion and $8 billion. This is consistent with both Treasury and the Joint Committee on Taxation estimates and is about 20 to 40 percent more than FSLIC estimated.

We estimated that the tax benefits for the 12 transactions on which we focused are over $5 billion on a present value basis--about 20 percent higher than the $4 billion plus FSLIC estimated.

Our estimate is different from FSLIC's because we used different assumptions. After discussions with tax experts from Treasury and the Joint Committee on Taxation, we decided to use a different weighted tax rate to reflect our assumption that the tax benefits would offset more income at the normal 34 percent corporate rate rather than at the 20 percent alternative minimum tax rate. We reduced the combined benefits of built-in-losses and income maintenance payments by assigning a tax basis to them as indicated by current IRS administrative practice. Because of tax planning opportunities that are available, we assumed more NOLs will be used.

This is the major reason our estimate is higher than FSLIC's. FSLIC did not consider tax planning but rather relied on their income projections for the new thrifts. We also used a 10-year Treasury rate in calculating the present value of the benefits.

Using these different assumptions for each of the 12 transactions reviewed, we compared the full government cost of the assisted transactions to the FSLIC cost of liquidating the failed thrifts. Our analysis suggests that liquidation could have been less costly for as many as a third of the transactions. FSLIC, however, was not statutorily required to consider tax benefits in deciding whether merger was less expensive than liquidation.

We also estimated the timeframes in which the acquirers' capital[1] could be recovered through tax benefits. In 9 of the 12 transactions, we estimate that the acquirers' tax benefits would equal the capital within an average of 3 years. The range was from 1 to 5 years. Two of the remaining transactions gave all the tax benefits to FSLIC. The other remaining one will not recover the capital through tax benefits during the period studied.

I want to emphasize that determining accurately the tax consequences of these transactions is very difficult. The true market value of failed thrifts' assets, which affects the tax, is not known, nor is the timing of asset sales. The future profitability of the new thrift and any holding company is difficult to estimate. And, it is difficult to anticipate the future business decisions of the new owners in light of the tax benefits available.

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[1] Capital, for the purpose of this analysis, does not include subordinated debt.

FHLBB officials have said that the tax benefits of the transactions were treated like any other asset and included in the negotiations. FSLIC did not have sufficient information to undertake an evaluation of tax benefits at the time the transactions were approved. FSLIC did not estimate the tax benefits of its 1988 transactions until January 1989. It seems highly unlikely that FSLIC got full value for these benefits in all the transactions.

The special tax benefits, which now apply to banks as well as thrifts, are used in the resolution of insolvent institutions. The need for the continuation of the special tax provisions depends on the extent to which FSLIC and FDIC are able to resolve failed institutions using insurance funds alone. In this regard, we believe it would be far preferable to take the actions we have recommended[2] to ensure the financial soundness of the insurance funds so that the insurers have the means to pay for, and thus fully recognize, resolution costs, rather than resorting to using special tax benefits.

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[2] Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GGD-89-47, Feb. 1989).

LACK OF INCENTIVES TO MANAGE ASSETS

The provisions of the agreements may not provide sufficient incentives for acquirers to actively manage and liquidate assets in the least costly manner to FSLIC and the federal government. Certain provisions shield the acquirers from loss on asset sales below book value and provide FSLIC with most of any gain above book value. Other provisions reduce the guaranteed return rate on covered assets over the term of the agreement but also guarantee a cash inflow for specified periods.

While FSLIC usually reimburses the new thrift for any difference between book value and recovery, the thrift can use the amount of the difference as a tax deduction. It is thus to the acquirer's benefit--from a tax perspective--to sell assets at the lowest percentage of book value, thus generating the largest loss. Also, if the acquirer increases the return on a covered asset, the FSLIC tax-free payment is reduced. Any return the asset actually generates is taxable.

Selling assets also reduces the covered asset pool and thus the amount of assets for which yield maintenance is provided. FSLIC attempted to provide incentives for acquirers to manage and dispose of assets most effectively by including gain and loss sharing agreements. All 12 transactions we reviewed included a gain sharing agreement; the provisions varied considerably. Five transactions included loss sharing agreements.

The yield maintenance guarantees, 10 years for Southwest Plan transactions and one other and 5 years in another one, decline over the period as an incentive to dispose of assets. Two transactions did not include a yield guarantee. Rates for the 8 Southwest Plan transactions ranged from 220 to 275 basis points over the average Texas cost of funds in year 1 to 90 to 200 points in year 10. These rates are meant to provide for operating expenses associated with the assets and profit. FSLIC was unable to estimate how much of the premium would be profit after operating expenses.

There is no certainty that the reductions in guaranteed yield agreements provide enough incentive for acquirers to properly manage and dispose of property. The acquirers' plans to sell an asset could be influenced by several factors, one would be any gain or loss sharing agreement with FSLIC. Another is the amount of profit included in the yield guarantee compared to the expected net profit after tax from reinvesting the proceeds from the sale. A final consideration would be the best timing for the use of tax benefits from the capital loss deductions.

Provisions in the transactions give FSLIC some control over the acquirers' management and disposition of assets. A typical provision obligates the acquirer to use its best efforts to manage and liquidate assets in a manner that will minimize losses. Also FSLIC may, for example, require an acquirer to sell a covered asset. We have concerns, however, about the enormous monitoring job facing FSLIC and how realistic it is to expect FSLIC to effectively utilize these controls.

SOLICITATION AND SELECTION

The Bank Board and FSLIC operate under very broad statutory guidelines with respect to soliciting and selecting acquirers for insolvent thrifts. The Bank Board's general procedures for marketing insolvent thrifts under its Southwest Plan, implemented in the Federal Home Loan Bank System's Ninth District, differed from procedures used elsewhere.

For example, most investors were asked to submit initial proposals without knowing which thrifts were being marketed, how FSLIC planned to combine them in groups, or the thrifts' current financial condition. This "blind" process, along with FSLIC's practice of combining less desirable insolvent thrifts in packages with those for which there was more interest, may have (1) decreased the likelihood of attracting the largest pool of qualified prospective bidders, (2) inhibited FSLIC's ability to evaluate the acceptability of proposals it did receive, and (3) resulted in a less efficient use of FSLIC's limited resources.

To enhance the probability of success, the plan targeted potential acquirers before the bidding process formally began. Then, FSLIC solicited proposals from interested thrift and nonthrift investors, including the targeted acquirers already identified and investors who had submitted proposals for, or expressed interest in purchasing Texas thrifts.

A few FSLIC officials, assisted by district bank staff and under the Bank Board's guidance, evaluated the proposals that were received on the basis of how well they met the Plan's objectives and decided whether each was acceptable under the Plan. These officials also decided which package of thrifts was best suited for each acceptable investor. The investors considered acceptable for a specific package were then told the identities of the thrifts in that package and requested to submit a detailed proposal. The bidders were not allowed to visit the subject thrifts or review their accounts. After detailed proposals were received, FHLBB staff and private contractors representing FSLIC negotiated the final terms of the transactions.

One of the primary problems with the Southwest plan process was the lack of knowledge about the condition of the thrifts and the continuing efforts of FSLIC officials putting together the deals to "mix and match" insolvent thrifts to match the apparent capacity of acquirers to put up capital and manage thrifts. The process was very fluid. And in several cases bidders became

insolvent and became part of the packages.

There was no typical transaction. In one Southwest Plan transaction, the Plan had identified a particular thrift as a targeted acquirer for one of the packages of thrifts. The FSLIC official who led the early negotiations said that thrift was told the identity of the thrifts in the package as part of the process of identifying targeted acquirers. Subsequently that thrift and 14 other bidders expressed interest in one or more of the insolvent thrifts in the package in response to FSLIC's request for proposals. The targeted thrift contacted by FSLIC was the only one which bid on all thrifts in the package. After reviewing the 15 bids, FSLIC and district bank staff selected that thrift as the one with which to begin negotiations.

Negotiations began in May 1988. The acquiring thrift's proposal would have left the new thrift with RAP capital of 1.5 percent. By July, FSLIC discovered the acquiring thrift was having trouble with its own solvency, and required it to raise additional capital to complete the transaction.

The thrift contacted a private investor which agreed to provide the needed capital. However, before completing the transaction, the investor hired an audit firm to evaluate the acquiring thrift's accounts. The audit and a district bank examination revealed the acquiring thrift's assets had been substantially overvalued and, in fact, the thrift was later found to be insolvent.

FSLIC ended negotiations with that thrift and placed it in the package of thrifts to be merged. FSLIC then added additional thrifts from another package to this package and started negotiating with the investor for the whole package of thrifts. The new package was not rebid to anyone else. The deal was then completed.

In contrast, a different process was used in one deal we reviewed that was not a part of the Southwest Plan. In this transaction, FSLIC asked 239 potential investors from its National Marketing List to attend a marketing conference if they were interested in bidding on certain insolvent thrifts with a certain asset size. The 25 investors who attended the conference were provided specific financial and other data on the thrifts. The bidders were allowed to review the accounts of the insolvent thrifts, a process called due diligence. Three proposals were received and cost estimates were made for each one. One was rejected because it exceeded the cost of liquidation. Negotiations started with the low cost bidder but broke down when that bidder could not obtain the financing needed for its proposal. Negotiations then started with the other bidder and finalized the deal.

COMPETITIVE ADVANTAGE

The assisted thrifts have certain financial advantages and protections that unassisted depository institutions do not. The advantages stem from the relatively low level of acquirer capital, the FSLIC assistance and guarantees, forbearances, and the tax savings.

As we have stated previously, the capital provided by acquirers is low in relation to the size of the thrift and this has historically created incentives to take risks.[3]

Having FSLIC assistance means the acquirer can count on some income for up to 10 years, regardless of what happens in the economy or thrift industry. For the 8 Southwest Plan transactions we reviewed, FSLIC estimates show its assistance makes up from about 50 to over 80 percent of projected gross income within the first five years.

Thrifts are now required to have a regulatory capital/liability ratio of 3 percent, rising to 6 percent at a rate tied to profitability in the industry. The 12 transactions resulted in 15 new thrifts. Financial information as of December 31, 1988, was available for 14. Capital to total liabilities ratios in 7 of the 14 was below 3 percent.

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[3] Failed Thrifts: Bank Board's 1988 Texas Resolution (GGD-89-59, Mar. 1989).

FSLIC also provides forbearances from other requirements, such as transactions with affiliates in the holding company. Forbearances shield the thrift from supervisory actions, and also let them undertake activities normally allowed for fully capitalized thrifts only. The FHLBB states that thrift supervisors have various controls over these forbearances.

Another advantage is that the new thrifts in Texas can use not only the FSLIC note to collateralize advances from the Federal Home Loan District Bank but also estimated future payments from FSLIC as collateral.

MONITORING MECHANISMS

Because of the complex nature of the transactions, FSLIC will have to monitor the assisted thrifts for lengthy periods of time. We question whether FSLIC has the resources to do this well.

One safeguard in most transactions is the provision in an agreement that FSLIC may take control of the new thrift if its regulatory capital drops to a certain level--often between 1 and 2 percent. Also, FSLIC may limit the payment of dividend under certain circumstances.

The complex agreements present a huge monitoring job for both FSLIC and Bank Board examiners and supervisors. The assistance agreements include a large number of controls. For example, FSLIC must approve: asset schedules, asset summaries; asset plans for large assets; asset budget summaries; asset sales requests; and asset term sheets if the thrift is providing the financing. For the 5 pre-December transactions we reviewed, there are over 87,000 covered assets with a book value of $7.1 billion. The 3 pre-December 1988 Southwest Plan thrifts had 552 large (over $5 million or $6 million) assets, each requiring a detailed asset plan.

Thrifts are also required to submit litigation schedules and reports; FSLIC must approve plans and budgets for significant litigation. (FSLIC reimburses the thrift for these expenses). FSLIC must also review reports showing the tax benefits of the transaction in the prior year; FSLIC can assess if it is receiving the percentage of the benefit agreed upon. FSLIC also reviews itemized charges for yield maintenance and capital loss payments submitted quarterly for payment. For Southwest Plan transactions, the new thrifts are required to submit three different consolidation plans for approval.

We have asked FSLIC for information on the pre-December transactions concerning the number of plans or reports submitted by thrifts, whether they were submitted on schedule, and how many

FSLIC has approved or denied. We also have asked for summary information on the monitoring requirements for the December transactions. FSLIC does not maintain such information centrally and was still in the process of obtaining it from the assisted thrifts for us as we were preparing this testimony.

VIABILITY OF NEW THRIFTS WAS CONSIDERED

The viability of the new thrifts is important to FSLIC because it insures the deposits of those thrifts and has an equity stake in most of them. FSLIC generally assessed the viability of the new entities before the transactions were approved. FSLIC's analyses showed that 9 out of 10 of the new thrifts we reviewed would be profitable, including the FSLIC assistance as income, within the first 5 years. (FSLIC had not done a viability analysis for thrifts in two of the transactions.)

We found, however, that FSLIC had not reduced the assistance income to the thrifts by the amount of the tax benefits they were required to return to FSLIC. Such reductions in income would affect both profitability and the regulatory capital levels projected, as FSLIC usually assumed all income will be retained. The implication of excluding tax benefits is that some of these new thrifts may not be viable without additional infusion of capital.

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The administration's bill authorizes the Resolution Trust Corporation to review and analyze these transactions, including all means by which costs can be reduced. We think this review should be required.

That concludes my prepared statement. My colleagues and I will be pleased to answer any questions.

ESTIMATED COSTS OF SOUTHWEST PLAN RESOLUTIONS ACTIONS THROUGH DECEMBER 31, 1988 (UNAUDITED)

Acquirer	Estimated costs of assistance agreements (cash value)	CASH BASIS [a]					
		Cash	Notes (principal)	Notes (interest)	Capital loss coverage	Yield subsidy	Other [b]
Coastal Banc SA	$237,225	$3,627	$32,639	$35,041	$112,752	$61,870	($8,704)
Southwest SA	3,521,024		569,682	490,050	1,738,990	762,302	
Merabank FSB	1,241,227		187,602	133,658	662,206	257,014	(19,253)
Gibson Group, INC.	2,379,171		535,743	472,633	752,155	617,277	1,363
Sunbelt SA	11,509,284		2,459,761	2,383,834	4,061,931	2,603,758	
Pulte Diversified CO.	1,993,689		511,840	526,547	562,961	429,733	(37,392)
Temple-Inland	2,808,221		710,146	681,456	804,641	700,065	(88,087)
Club Corporation	1,620,451		264,443	258,962	538,782	571,406	(13,132)
Adam Corporation	2,293,491		303,408	283,990	950,953	819,216	(64,076)
Americity FSB	281,661		21,233	18,945	142,163	108,324	(9,004)
CFSB Corporation	3,377,666		836,702	807,083	946,449	821,432	(34,000)
Utley Ford	8,908,369		2,106,126	1,925,459	2,743,863	2,049,848	83,073
Pacific USA Holdings	986,968		161,738	150,370	365,304	309,556	
Center Corporation	813,222		222,900	246,702	256,318	87,597	(295)
Hyperion Partners	2,200,353		261,135	242,805	946,338	717,982	32,093
TOTAL	$44,172,032	$3,627	$9,185,098	$8,637,535	$15,585,806	$10,917,380	($137,414) [b]

[a] All figures in thousands.

[b] "Other" column includes mark to market adjustments, prepayment penalties on FHLB advances, and projected future income from FSLIC ownership interests and return of tax benefits.

Source: FSLIC Records

ESTIMATED COSTS OF SOUTHWEST PLAN RESOLUTIONS ACTIONS THROUGH DECEMBER 31, 1988 (UNAUDITED)

Acquirer	Estimated cost of assistance agreements (present value)	PRESENT VALUE BASIS[a] Cash	Notes (principal)	Notes (interest)	Capital loss coverage	Yield subsidy	Other[b]
Coastal Banc SA	$146,226	$3,627	$12,584	$22,569	$52,001	$52,888	$2,557
Southwest SA	1,980,323		219,637	290,136	817,137	653,413	
Merabank FSB	665,655		69,122	96,177	291,277	215,326	(6,247)
Gibson Group, INC.	1,313,780		197,393	297,739	317,319	481,404	19,925
Sunbelt SA	6,166,657		918,691	1,492,472	1,721,553	2,033,941	
Pulte Diversified Co.	1,090,233		191,189	330,929	238,959	335,846	(6,690)
Temple-Inland	1,489,130		253,385	426,691	329,844	540,300	(61,090)
Club Corporation	999,545		98,766	164,138	294,455	446,061	(3,875)
Adam Corporation	1,287,382		113,319	178,442	399,893	645,349	(49,621)
Americity FSB	160,787		7,823	11,790	59,456	84,466	(2,748)
CFSB Corporation	1,846,254		313,405	515,294	404,391	639,966	(26,802)
Utley Ford	5,046,238		622,383	1,234,481	1,346,093	1,546,902	96,399
Pacific USA Holdings	566,203		63,990	96,606	163,932	241,675	
Centex Corporation	428,770		87,039	160,305	113,898	67,734	(206)
Hyperion Partners	1,372,166		102,760	154,315	520,792	561,219	33,080
TOTAL	$24,559,369	$3,627	$3,471,486	$5,472,084	$7,071,000	$8,546,490	($5,318)[b]

---

[a] All figures in thousands.

[b] "Other" column includes mark to market adjustments, prepayment penalties on FHLB advances and projected future income from FSLIC ownership interests and return of tax benefits.

Source: FSLIC Records

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United States General Accounting Office

GAO

Report to Congressional Requesters

February 1989

TROUBLED FINANCIAL INSTITUTIONS

Solutions to the Thrift Industry Problem

GAO/GGD-89-47

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-232785

February 21, 1989

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking,
Finance and Urban Affairs
House of Representatives

The Honorable Gerald D. Kleczka
House of Representatives

The Honorable Stan Parris
House of Representatives

The Honorable Steve Bartlett
House of Representatives

This final report is in response to your request that we study solutions to the savings and loan industry problem. The final report is very consistent with the draft made available to you, other Members of Congress, and the Administration for comment on December 9, 1988.

The draft report provided the basis for testimony we delivered earlier this year to your Committee, the House Budget Committee, and the Senate Banking Committee containing our recommendations for solving the problem. Several factors could well push higher our December estimate of $85 billion in additional funds that will be needed to solve the problem. For example, costs could increase if interest rates go up further, a recession occurs, or the condition of thinly capitalized, but solvent, institutions deteriorates. Rather than develop new estimates for the final report, we believe it is best to await the details of the Administration's plan and analyze the dollar implications then. In that regard, we are pleased that the outline of the plan President Bush proposed on February 7, 1989, is consistent with the thrust of the reforms we have recommended—such as dealing quickly with remaining insolvent savings and loans, providing sufficient funds to accomplish the task, and making the supervisory agency independent of the Federal Home Loan Bank Board.

We look forward to continually assisting the Committee as it addresses this critical issue during the next several months. We are providing copies of the report to other interested Members of Congress, appropriate committees, executive branch agencies, and the public.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

Purpose

The federal deposit insurance system for banks and thrift institutions was established by the federal government in the early 1930s. This system, which protects about $2.7 trillion in deposits in the Nation's banks, thrift institutions, and credit unions, plays a vital role in sustaining public confidence in the safety and soundness of the U.S. financial system. It has, however, incurred unprecedented costs in recent years, and the fund that insures thrift institutions, the Federal Savings and Loan Insurance Corporation (FSLIC), has become insolvent.

The House Banking Committee asked GAO to look into the possibility of merging FSLIC with the Federal Deposit Insurance Corporation (FDIC), the fund that insures deposits in commercial banks and some savings banks, as one option for preserving the soundness of the deposit insurance system. Accordingly, this report discusses the pros and cons of merger as well as a number of steps that need to be taken to restore the deposit insurance system to financial health and to ensure that FSLIC's experience is not repeated.

Background

In the last few years, insured depository institutions have become insolvent at rates that were only exceeded during the Great Depression: 200 banks failed in 1988 and although FSLIC acted on about that same number of thrifts in 1988, at the end of the year about 350 insolvent thrifts were still open.

As of December 31, 1987, FSLIC had a capital deficit of nearly $14 billion, and steps that have been taken to augment its funding with higher premiums and an additional $10.8 billion recapitalization loan are proving inadequate. Although FDIC had reserves of $18.3 billion at the end of 1987, the ratio of its reserves to insured deposits at that time was at its lowest point in years. In 1988 FDIC reserves declined and they are now below the minimum standard of fund adequacy—1.1 percent of insured deposits—set forth in legislation.

Results in Brief

Three things need to be done, as concurrently as possible, to help restore the deposit insurance system to financial health and to best ensure that FSLIC's experience is not repeated: (1) FSLIC needs to use different procedures to resolve insolvencies as quickly as possible. (2) To minimize the ultimate magnitude of insurance fund losses, the federal regulatory structure needs to be reformed so that both FDIC and FSLIC can better manage risks. These reforms include reorganizing FSLIC and removing it from the jurisdiction of the Federal Home Loan Bank Board (FHLBB).

(3) Adequate funding must be provided to resolve problem cases and to restore FSLIC's reserves to an adequate level.

Unfortunately, no one knows precisely how much it will cost to restore FSLIC to financial health. GAO estimates that if action is taken quickly to deal with insolvent institutions and if interest rates remain at their current levels, FSLIC will need at least $85 billion more than the funding it anticipates receiving over the next 10 years.

Of this $85 billion in additional funding, $26 billion is for covering cases acted on in 1988, $34 billion to resolve the remaining 350 insolvent cases, $5 billion for unanticipated losses, and $20 billion for establishing an adequate reserve. Although the thrift industry can probably contribute some of the additional money needed, as much as $75 to $80 billion may have to come from the federal government unless others, such as FDIC-insured banks and depositors, are required to share the cost.

Certain drawbacks make it inadvisable to merge the FSLIC and FDIC insurance funds at this time. But merger of the administrative functions of the two agencies could help provide the independence and staff capability needed to effectively deal with the remaining insolvent thrifts.

GAO's Analysis

New Resolution Approach

Regulators and Congress have resisted massive closings of insolvent savings and loans in the hope that the fortunes of these institutions would reverse themselves. This hope has proven both futile and costly, as indicated by industry losses of $9.4 billion through September 1988. Quick action is needed to avoid further escalation of costs and damage to our financial system and to create the environment for implementation of badly needed reforms to regulations. (See pp. 45 to 50.)

In late 1988 FSLIC increased the rate at which it acted on the cases of insolvent thrifts. FSLIC's strategy, developed in part to get around its lack of funds, has depended heavily on assisted merger agreements that defer cash outlays for as long as 10 years through the use of notes and guarantees.

GAO is concerned because extensive government financial commitments beyond FSLIC's available resources were made without first undertaking needed reforms. In addition, GAO believes that the assisted merger agreements may be more costly than other approaches that could have been used if FSLIC had enough money. FSLIC, pursuant to its laws, only considers costs to its fund, not the government as a whole, in deciding what course of action to take. For example, FSLIC does not count tax losses to the government as costs. The magnitude of this problem requires a broader perspective to be taken. (See pp. 52 to 55).

GAO believes FSLIC should abandon its approach of tying its actions on problem cases so closely to the type of deals it has been using. Instead, the government should promptly take control of insolvent institutions until they can be rehabilitated, merged, or liquidated on an orderly and cost-effective basis. It would be desirable for an arrangement to be devised by which FSLIC could make use of the personnel resources of FDIC or other federal agencies to carry out such a policy. (See pp. 56 to 59.)

Deposit Insurance Reform

Higher capital requirements, better adherence to rules for closing insolvent institutions, better supervision of problem institutions, and more flexibility in setting insurance premiums are all needed to minimize the chance that the deposit insurance system in the future will not once again face the prospect of significant unfunded insurance losses. The need for these reforms is illustrated by the existence at the end of 1987 of 685 solvent but weak thrifts and commercial banks with assets of about $370 billion. If the condition of undercapitalized institutions were to deteriorate further, as would happen, for example, if interest rates were to rise significantly, insurance losses for FDIC and FSLIC could increase sharply. (See pp. 66 to 72.)

To most effectively implement these reforms, FSLIC will need more independence. Presently, FSLIC is under the direction of the Federal Home Loan Bank Board, which promotes, as well as regulates, the thrift industry. GAO believes that FSLIC should be reorganized under independent management so that it consists of two parts: a "good company" fund for thrifts that are healthy or can become so in a reasonable period of time; and a "bad company" fund for those institutions that need to be rehabilitated, merged, or liquidated. Good company institutions should be responsible for capitalizing their fund. Bad company institutions would be restricted from making new loans and would also be restricted in the rates they pay on deposits. (See pp. 83 to 86.)

Healthy thrifts that meet FDIC's capital adequacy criteria should be offered a choice of joining the FDIC or the good company fund. The healthy thrifts should be required to pay the same capital contribution and regular premiums regardless of which fund they join. Part of this total amount would be used to pay a portion of the bad fund bills. (See p. 89.)

This approach has several benefits. First, institutions in the bad company fund would be isolated from the rest of the depository institutions industry and unable to compete with it. Second, an industry contribution could be structured to devote most of it to funding the insurance needs of healthy thrifts, thereby benefitting the financial system as a whole because healthy thrifts would immediately come under the authority of an independent, adequately funded insurance fund. (See pp. 83 to 89.)

Finally, the business decisions made by individual healthy thrifts about whether to join FDIC or the new good company fund would provide useful insight into the need for, and viability of, an independent thrift industry as it is presently structured. (See p. 89.)

Provision of Adequate Funding

Even if action is taken quickly to resolve insolvent institutions and no adverse upward movement occurs in the level of interest rates, GAO believes that FSLIC will need at least an additional $85 billion to resolve problems in the industry and restore its financial condition. Delays in dealing with insolvent institutions or increases in the level of interest rates will only worsen the condition of insolvent institutions and push weak institutions into insolvency, thereby adding to the costs of ultimately dealing with the problem. (See pp. 34 to 42.)

GAO believes the thrift industry should pay as much of the shortfall as possible. GAO recognizes that the industry already has a substantial commitment resulting from the special premium assessment that FSLIC expects to continue for the next 30 years and, possibly, beyond. This special assessment has, since 1985, more than doubled thrift insurance premiums. Continuation of the special assessment or additional charges on industry revenues could weaken healthy thrifts and thereby prove self defeating. (See pp. 80 to 83.)

In deciding how to finance the $85 billion shortfall, Congress must make difficult choices about who should pay. No objective basis exists for fairly dividing up the burden of paying the costs of making FSLIC financially sound; this has to be decided on the basis of value judgments that can be made only by Congress. Congress must decide whether to rely on general revenues, other industry contributions, or a combination of the two. Industry sources that can be considered include banks, credit unions, other financial services firms offering deposit-like products, and depositors. GAO believes that if reliance is placed on seeking funds from any of these industry sources, the contribution should be spread as widely as possible to minimize the burden of individual contributions and to avoid placing some sectors of the industry at a competitive disadvantage. (See p. 97.)

Why Full Merger Is Not Appropriate at the Present Time

Simply merging the insurance funds cannot solve the FSLIC problem. GAO strongly advises against further weakening the deposit insurance system through a merger in which FDIC's reserves and premium income, both of which are needed for bank problems, are simply diverted to attempt to cover some of FSLIC's losses. (See p. 104.)

Before considering a full merger of the deposit insurance system, Congress first should implement changes to establish comparable regulatory ground rules for the two industries and ensure that both funds are financially sound. Congress must also decide whether there is a need for specialized housing finance institutions. After these actions have been accomplished, full merger might better be considered as part of an overall effort to further ensure the integrity of the deposit insurance system and to simplify the regulatory structure for depository institutions. (See pp. 100 to 104.)

Recommendations

GAO recommends that Congress quickly adopt a comprehensive plan to pay FSLIC's bills and to minimize the chance that the FSLIC situation is repeated. To accomplish this at as low a cost as possible, GAO is recommending a specific set of actions designed to

- promptly take control of insolvent institutions and fully resolve these cases as quickly as possible. To facilitate such action, an administrative merger of FDIC and FSLIC should be considered (see p. 62);
- change the regulatory structure to make FSLIC independent, and provide FSLIC and FDIC with the authority needed to better ensure the soundness of the deposit insurance system (see p. 77);
- implement a plan for raising at least $85 billion over the next 10 years (the majority of which is needed in the next 3 years), financed as much as possible from thrift industry contributions (see p. 98);
- reorganize an independent FSLIC into good company and bad company funds and permit the new entities to draw on the personnel of FDIC or

other federal regulatory agencies to help in resolving problem cases (see p. 98);

- allow healthy thrifts to convert to FDIC's insurance fund with payment of appropriate fees (see p. 98); and
- establish a special board to protect taxpayers' interest by overseeing the expenditures of any federal funds provided to resolve these cases over the next several years (see p. 98).

Agency Comments

FHLBB, FDIC, the Department of the Treasury, the Board of Governors of the Federal Reserve, and the National Credit Union Administration provided written comments on a draft of this report (see pp. 140 to 151). FHLBB agreed that additional funds were needed and that the FSLIC and FDIC funds should not be merged. However, FHLBB disagreed with GAO's recommendations for taking immediate control of insolvent institutions and for making FSLIC independent because it did not see where such actions would result in additional benefits over and above those attainable by providing additional funding to FSLIC.

FDIC, Federal Reserve, and the National Credit Union Administration generally agreed with GAO's findings regarding insurance fund merger and the need for new funding, quick action, and deposit insurance reform.

In a January 26, 1989, letter, Treasury declined to comment on our findings and recommendations pending development of the Administration's proposal. But the President's February 7, 1989, proposal appears to incorporate many of the key features recommended in this report.

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Abbreviations

CEBA	Competitive Equality Banking Act of 1987
DIDMCA	Depository Institutions Deregulation and Monetary Control Act of 1980
DINB	Deposit Insurance National Bank
FDIC	Federal Deposit Insurance Corporation
FHLBank	Federal Home Loan Bank
FHLBB	Federal Home Loan Bank Board
FHLBS	Federal Home Loan Bank System
FICO	Financing Corporation
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office
GNP	Gross National Product
ICC	Income Capital Certificates
MCP	Management Consignment Program
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NWC	Net Worth Certificate
OCC	Office of the Comptroller of the Currency
RAP	Regulatory Accounting Principles
ROA	Return on Assets

Chapter 1

Introduction

The federal deposit insurance system for banks and thrift institutions was established by the federal government in the early 1930s. The system has experienced heavy costs in recent years, and the fund that insures thrift institutions, the Federal Savings and Loan Insurance Corporation (FSLIC), has become insolvent. The Chairman and three Members of the House Committee on Banking, Finance and Urban Affairs asked us to look into the possibility of merging the deposit insurance funds as one option for preserving the soundness of the deposit insurance system. This report discusses the pros and cons of merger in the context of a number of steps that we believe need to be taken to help restore the deposit insurance system to financial health and to best ensure that FSLIC's experience is not repeated.

Background

Federal deposit insurance protects depositors' money up to $100,000 when insured financial institutions fail and plays a vital role in sustaining public confidence in the safety and soundness of the U.S. financial system. Deposit insurance is administered by three federal agencies that together make up the deposit insurance system. The Federal Deposit Insurance Corporation (FDIC), an independent agency, insures deposits in all commercial banks and some savings banks. FSLIC, an affiliate corporation of the Federal Home Loan Bank System (FHLBS) governed by the Federal Home Loan Bank Board (FHLBB), insures deposits in all savings and loan associations and other savings banks. In this report, "thrift" is used to refer to all FSLIC-insured institutions. The National Credit Union Share Insurance Fund (NCUSIF), a fund administered by the National Credit Union Administration (NCUA), insures the share deposits of credit unions. These three agencies insure $2.7 trillion in deposits in about 32,000 depository institutions that have total assets of $4.7 trillion. (See table 1.1.)

Table 1.1: Characteristics of Depository Institutions as of December 31, 1987

Dollars in billions

	FDIC	FSLIC	NCUSIF[a]
Number of insured institutions	14,184	3,147	14,364
Amount of total assets in insured institutions	$3,263	$1,252	$174
Amount of deposits in insured institutions	$2,540	$933	$159
Insured deposits	$1,659	$855	$157
Uninsured domestic deposits over $100,000	$543	$78	$2
Uninsured foreign deposits	$338	i	•
Insured deposits as a percentage of total assets (percent)	51%	68%	90%

[a] Includes 29 federally insured corporate credit unions with assets of $12 billion and deposits of $11 billion.

Sources:
FDIC: FDIC 1987 Statistics on Banking and FDIC's 1987 Annual Report.
FSLIC: GAO Thrift Industry Data Base Compiling Institutions' Quarterly Reports of Condition.
NCUSIF: NCUA 1987 Statistics for Federally Insured Credit Unions and NCUA 1987 Annual Report.

The biggest problem facing the deposit insurance system is FSLIC's financial condition. At the end of 1987, 505 of FSLIC's 3,147 insured thrift institutions were insolvent, and another 435 were inadequately capitalized as measured by generally accepted accounting principles (GAAP). In its audited December 31, 1987, balance sheet, FSLIC reported a capital deficit of $13.7 billion. However, FDIC has also experienced large insurance costs in recent years. Although FDIC had reserves of $18.3 billion at the end of 1987, the ratio of its reserves to insured deposits at that time was the lowest it has been in years. FDIC expects the financial statements for 1988 to show that reserves declined by about $4 billion, and, in 1988, for the first time, the reserve ratio has fallen below the legislative standard for adequate reserves.[1] NCUSIF, even though it has experienced some years of relatively large losses since the late 1970s, is currently in the best condition of the three funds because it was recapitalized in 1985 by congressional action.[2] Table 1.2 shows insurance expenses since 1980 for the three funds.

---

[1] The standard for insurance fund reserves that exists in legislation is discussed in appendix II.

[2] The Federal Credit Union Act Amendment to the Omnibus Deficit Reduction Act of 1984 (Public Law 98-369) required each insured credit union to deposit and maintain in the insurance fund 1 percent of its insured member share accounts. The deposits are accounted for as assets on the books of the individual institutions. See appendix VI for a more detailed discussion.

Table 1.2: Annual Deposit Insurance Expenses During the 1980s

Dollars in millions

Year	FDIC	FSLIC	NCUSIF[a]
1980	$(34.6)[b]	$23.2	$32.5
1981	720.9	936.1	43.9
1982	869.8	865.3	79.3
1983	834.0	1,018.4	55.6
1984	1,148.0	2,113.5	28.1
1985	1,778.7	3,414.3	25.5
1986	2,783.5	13,269.7	37.9
1987	3,064.9	10,925.4	55.7

[a] NCUSIF totals are for the fiscal years ending September 30.

[b] FDIC recovered more from adjustments to prior years' losses than it spent on insurance and assistance in 1980.

Source: Audited annual financial statements.

The Insurance Funds Are Part of a Complex and Conflicting Regulatory Framework

State and federal laws define allowable activities for banks and thrifts, and federal and state regulatory authorities grant charters that can only be revoked by these same agencies. State and federal regulatory and supervisory agencies also establish and monitor compliance with standards for safe and sound operation and can order an institution to halt improper practices. Because of the role played by these agencies, the deposit insurance funds, in many instances, act much more as passive insurers than do property and casualty insurance companies that provide automobile, liability, and similar insurance coverage.

The insurance funds bear the financial loss if those responsible for chartering, regulating, and supervising institutions fail to constrain an institution's risk within the limits that its capital can absorb.[3] In some situations, the insurance fund will provide financial assistance to keep an institution operating, an action that may be accompanied by replacing an institution's management. However, the insurance funds usually obtain control of an institution only when its charter is revoked. The insurance funds then pay off depositors or transfer their accounts to another institution, absorbing any loss when the actual value of the failed institution's liabilities exceeds the value of its assets.

---

[3] Capital held by depository institutions represents the ownership claim on the institution and also serves as a buffer against losses to the insurance fund. However, capital is defined in different ways. Under GAAP, capital consists almost entirely of equity capital—common stock and retained earnings. Capital as defined by bank and thrift regulators includes other items as well. Throughout this report we use the GAAP definition of capital as we have done in previous reports on the condition of the industry and the insurance funds.

Similarities and differences in the treatment of banks and thrifts by the federal and state chartering and regulatory agencies have created an administratively complex and conflicting environment for managing deposit insurance risks. Banks and thrifts compete for essentially the same deposits. However, they operate under different rules regarding their allowable activities, capital requirements, and branching and merger authority, among other things. Within each industry component, rules also differ between state and federally chartered institutions.[4] Table 1.3 summarizes the different relationships between chartering agency, regulator/supervisor, and insurer according to whether the institution is a bank or thrift, state or federally chartered, or a member or nonmember of the Federal Reserve System. The table also shows the number of institutions and total assets for each category of institution.

Table 1.3: Structure of the Regulatory/Supervisory Environment of Insured Institutions, December 31, 1987

Dollars in billions

Type of institution	Number of institutions	Total assets in institutions	Chartering agency	Regulator/supervisor
FDIC-insured				
National banks	4,620	$1,775	OCC	OCC
State member banks	1,087	529	State	FRS/State
State nonmember banks	7,992	687	State	FDIC/State
Federal savings banks	22	45	FHLBB	FHLBB
State savings banks	463	217	State	FDIC/State
FSLIC-insured[a]				
Federal savings institutions	1,379	$437	FHLBB	FHLBB
State savings institutions	1,768	814	State	FHLBB/State

OCC = Office of the Comptroller of the Currency
FRS = Federal Reserve System

[a] Total assets for FSLIC-insured institutions does not equal the total asset amount in table 1.1 due to rounding.

In addition, FDIC and FSLIC present two different models of the deposit insurance function. FSLIC is under the authority of FHLBB and is therefore not independent. Although this relationship provides the potential for close coordination of regulatory, supervisory, and insurance matters, it also compromises the independence of the insurance function. The insurance function is compromised because the FHLBB must balance its concern with accomplishing what is best for maintaining a sound insurance fund against other activities, such as promoting the thrift industry's housing finance role. FDIC is more independent, both in structure and operation. For this model to work, however, FDIC must coordinate with federal and state regulatory and chartering authorities.

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[4] For example: banks are more limited than thrifts in the types of securities they can own; certain state-chartered banks are permitted to sell insurance, while national banks are not; and federal savings and loans also have greater restrictions on their directly owned real estate investments than some of their state-chartered counterparts.

The complexity of the relationship between the deposit insurance agencies and the chartering and regulatory agencies, as well as the largely passive role played by the insurance funds in controlling risk taking, greatly complicates issues that need to be considered in deciding how best to improve management of risks underwritten by the deposit insurance agencies.

Deposit Insurance Financing

Deposit insurance is set up as an industry-financed arrangement subject to federal requirements. Institutions pay premiums, called assessments, that are used to pay for operating expenses and current insurance losses and to build up reserves against future losses. Interest income earned by investing reserves in Treasury securities and income from liquidating assets supplement premium income. The maximum premium levels are set by law, with each institution within an insurance fund paying at the same rate, regardless of that institution's activities or financial condition. FDIC and FSLIC can attain additional flexibility in funding by borrowing, issuing promissory notes, taking over responsibility for repaying loans, and issuing guarantees. The powers FDIC and FSLIC have for setting premiums and borrowing are summarized in table 1.4.

Table 1.4: Sources of Financing for FDIC and FSLIC

Power	FDIC	FSLIC
Annual premium assessment	One-twelfth of 1 percent of total domestic deposits.	One-twelfth of 1 percent of total deposits.
Supplemental assessment	None	One-eighth of 1 percent of total deposits (annually levied in four installments for the first time in 1985).
Borrowing from insured institutions	None	Deposit from insured institutions of up to 1 percent of total institution deposits can be required. Interest must be paid on the deposit.
Treasury borrowing	$3 billion	$750 million
Other borrowing	None	Borrowing from Federal Home Loan banks (no statutory limit).
Other financing	Promissory notes and guarantees issued to assisted institutions (no statutory limit). Assumption of the liability for repaying loans that a failed or assisted bank had obtained from a Federal Reserve bank or a Federal Home Loan bank.	Promissory notes and guarantees issued to assisted institutions (no statutory limit). Assumption of the liability for repaying loans that a failed or assisted thrift had obtained from a Federal Reserve bank or a Federal Home Loan bank. $10.8 billion recapitalization program authorized by the Competitive Equality Banking Act of 1987 (CEBA).[a]

[a] CEBA authorized FHLBB to establish a special entity, the Financing Corporation (FICO), that has begun to borrow up to its $10.8 billion ceiling to be used to recapitalize FSLIC. The principal will be repaid by zero coupon bonds purchased by FICO with funds provided by the Federal Home Loan banks; the interest will be paid from FSLIC premium income and, if necessary, the supplemental assessment pledged for this purpose.

How FDIC and FSLIC Resolve Failed Institutions

When the deposit insurance funds obtain control of a problem institution, they usually resolve the case through either a liquidation or a merger. In a liquidation, the insurance fund can pay off the insured depositors and, in return, as receiver, acquire control of all of the failed institution's assets. The insurance fund can then sell these assets to try to recover as much value as possible, a process that can take months or several years.[illegible] The proceeds from the sale are used to pay back the

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[illegible] In the liquidation process, an insurance fund may sell some acquired assets right away and may manage others for quite a while before selling them. The fund can either manage assets itself or contract with other parties. In deciding when and how to sell assets, the insurance fund, as receiver, seeks to obtain maximum return for itself and for other creditors of the receivership.

insurance fund, uninsured depositors, and general creditors on a pro rata basis (i.e., according to the size and priority of their claims against the institution).

In merger transactions, which are used much more frequently than liquidation, the insurance funds combine one or more insolvent institutions with a solvent one, transfer some or all of the insolvent institution's assets and liabilities to another institution, or arrange for the institution to be acquired by an individual or company that currently does not own that type of institution. Mergers usually require a smaller contribution from the fund because the acquiring institution assumes the deposits of the failed bank and the insurance fund's outlay is reduced to that needed to make the arrangement attractive to the purchasers and economically viable.[illegible] In the past several years, and especially during 1988, FSLIC has kept its initial cash outlays as low as possible by paying its contribution to the acquiring institution in promissory notes or guarantees rather than making cash payments at the time of the merger.

When problem cases are resolved by merger, they have the effect of protecting all liabilities of insured institutions because the acquiring institution usually assumes responsibility for all of the failed institution's liabilities, not just insured deposits. As a result, de facto protection has usually been provided for deposits over $100,000, foreign deposits, and other creditors of depository institutions.

Objectives, Scope, and Methodology

In their letter of May 14, 1987, the Chairman and three Members of the Subcommittee on Financial Institutions, Supervision, Regulation, and Insurance of the House Committee on Banking, Finance and Urban Affairs requested that we examine the advisability and feasibility of merging FDIC, FSLIC, and/or NCUSIF. This broad request also asked us to assess the outlook for each of the funds and to consider the financial, personnel, and policy issues associated with a funds merger.

In subsequent discussions, we agreed on objectives and scope limitations in light of the continued deterioration of FSLIC's financial condition and our related work. We agreed that our report would describe the condition of FSLIC and FDIC and discuss their future revenue requirements. We agreed that we would examine the question of merger in the context of

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[illegible] The funds' outlays can involve eliminating the net worth deficit of the insolvent institution and/or purchase of substandard assets that the acquiring institution does not want to retain. In the cases where the insurance fund acquires assets, these are managed and liquidated in the same way as in a regular liquidation.

alternatives for improving the financial condition of the insurance funds and discuss administrative processes that would be affected by a funds merger. We also agreed to exclude the NCUSIF in our assessment and to concentrate as much as possible on deposit insurance issues rather than issues more generally associated with the regulatory status of depository institutions. We worked on this assignment between July 1987 and February 1989.

Our Approach to Assessing the Advisability and Feasibility of an Insurance Fund Merger

It is now widely recognized that something must be done to restore FSLIC to a solid financial footing and to improve the management of risks underwritten by the deposit insurance funds so that FSLIC's current condition is not repeated. In achieving this result, decisions are needed on (1) how to equitably distribute the burden of financing resolution of the thrift industry's insolvent and otherwise troubled institutions and (2) how to better protect the deposit insurance funds from risks generated by depository institutions. These issues are fundamental and must be resolved regardless of whether or not the deposit insurance funds are merged. Our approach to the merger question therefore involved an assessment of whether or not various types of mergers of the funds could, after the benefits and costs are weighed, in any way contribute to the quality of actions to resolve these issues.

A large amount of judgment is involved in working through the difficult choices that must be made about how to restore financial soundness and improve the management of risk in the deposit insurance system. In this report we render a number of judgments on how those objectives can best be met. These judgments are based on our past work on the deposit insurance system; on the structure of depository institutions' regulation, oversight, and supervision; and on the financial condition of the depository institutions industry.

Our Approach to Estimating the Financial Needs of FSLIC

In May 1988, we pointed out in congressional testimony that "the eventual costs of restoring the thrift industry's financial health are likely to exceed the funds that FSLIC will have available."[7] The estimates contained in this report attempt to provide as realistic a basis as possible for analyzing the choices for restoring FSLIC's financial soundness. Our estimate includes money to resolve presently identified problem cases, provide for insurance losses among other institutions, bring reserves to an adequate level so the insurance funds have the resources to close insolvent institutions in the future, and pay administrative expenses and financing costs.

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[7] The Federal Savings and Loan Insurance Corporation—Current Financial Condition and Outlook, (GAO/T-AFMD-88-12, May 19, 1988), p. 11. This is referred to below as the Wolf statement.

In developing our estimates of FSLIC's need for money, we carried our analysis out to the end of calendar year 1998. We assume that the goals of paying the full costs for resolving problem cases and of restoring adequate reserves could both be accomplished by that date. We selected this period because FSLIC has used it in presentations to Congress and because we believe that it is long enough to deal with the FSLIC insolvency and to finance activities associated with resolving the cases of problem thrifts.

The starting points in our analysis of FSLIC's financial needs were audited insurance fund financial data as of December 31, 1987, and industry condition as of that same date. We then made estimates of activity for the 11-year period from 1988 through 1998 based on FHLBB published data on fund revenue and expenses. We assumed that any new funding arrangements could be provided beginning in 1989 and extended as needed through 1998. Our estimates are based principally upon information available as of September 30, 1988. We did, however, adjust our analysis to take into consideration the readily available data concerning resolution activity that occurred in the last quarter of 1988. See page 39.

Our estimates of insurance losses represent the full cost of acting by 1991 to resolve the cases of inadequately capitalized thrifts that already are insolvent or are likely to become so by 1991, with insolvency measured on a GAAP basis. Full resolution as we have used the term means resolving problem thrift cases so that (1) the full economic loss inherent in each situation has been dealt with and (2) all surviving institutions involved in FSLIC transactions meet prevailing capital adequacy standards without the need for continuing guarantees or other insurance fund involvement.[a]

Because of uncertainties regarding the true condition of problem thrifts and the future economic environment, it is not possible to estimate

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[a] This concept of full resolution is that generally followed by FDIC in resolving the cases of failed institutions. FDIC has departed from the full resolution concept in dealing with some large bank failures.

FSLIC's financial needs with much precision.[9] The problems that have given rise to FSLIC's losses have arisen through a combination of factors that include fraud and insider dealing, changes in interest rates and other economic conditions, continuing problems in certain regional sectors of the economy, poorly implemented deregulation of financial markets, and increased competition in markets. Factors such as these are not predictable. As a result, we made certain assumptions that are explained in the next section.

Assumptions Used in Our Estimates

Over the past decade, the combined deposits in thrifts and FDIC-insured banks grew at 8.2 percent, approximately the same rate as the 8.5 rate of increase of nominal Gross National Product (GNP). Although there were significant variations in the year-to-year pattern of growth within each industry, overall thrift deposits grew at a faster rate than FDIC-insured bank deposits (9.6 percent and 7.7 percent, respectively). To simplify our analysis, we have made our revenue calculations on the assumption that deposits in both FSLIC- and FDIC-insured institutions will grow at an average annual rate of about 7 percent per year, approximately the rate of increase in nominal GNP projected by Data Resources Incorporated. This assumption of deposit growth is the same one FSLIC has used in its projections.[10] Nevertheless the ability of thrift institutions to continue to attract deposits in line with GNP growth is by no means a foregone conclusion. The possibility that FSLIC-insured institutions may experience slower growth in deposits is discussed in chapter 2.

Any estimates of deposit insurance costs are, of course, greatly dependent on the assumptions made about the economic environment. In making our assessment of the magnitude of the financial demands facing the deposit insurance funds, we have tried to avoid both overly optimistic and unduly pessimistic assumptions regarding economic events. We have therefore made the following simplifying assumptions:

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[9] Our estimate of what FSLIC needs to regain financial health will be greater than either (1) the estimate of the minimum amount of money FSLIC needs through 1998 simply to maintain a positive cash flow or (2) the provision for loss that would be appropriate to include in FSLIC's financial statement. An estimate based on maintaining a positive cash flow can reflect deferral of problem recognition and arrangements to deal with problems that do not reflect full costs. A provision for loss in FSLIC's financial statement is based primarily upon supervisory cases that have been referred to FSLIC for case resolution, whereas we have also tried here to take into account other losses and expenses that could reasonably be anticipated for purposes of planning to restore FSLIC to sound financial condition.

[10] Instead of an exact 7 percent annual rate, FSLIC applies a growth rate of 1.75 percent per quarter, which translates to an annual growth rate of 7.2 percent. We have followed FSLIC's assumption.

- The economy will not experience an extended recession or other new significant setbacks.
- Presently depressed sectors of the economy, such as those involving energy, agriculture, and real estate in certain areas of the country, will experience neither a dramatic recovery nor suffer added major adversities.
- The level and structure of interest rates in the economy will not change significantly, and interest rates faced by the insurance funds in financing resolution costs will be 8 percent for intermediate-term notes (average maturity of 5 years) and 10 percent for long-term bonds financed through FICO.
- FSLIC will experience losses on assets of resolved institutions that range between the high rates it is currently experiencing and the lower rates FDIC is currently experiencing.

The assumptions regarding the economy and interest rates correspond to those that FSLIC has used in making projections. FDIC officials said that they are reasonable to use for planning purposes.

Sources of Information

To complete our analysis, we obtained information from the laws governing the deposit insurance system; professional literature concerned with deposit insurance risk management and fund condition; statistical data prepared by FDIC, FHLBB, NCUA, and other regulatory agencies; agency records; and discussions with officials of FDIC, FHLBB, NCUA, the Federal Reserve board, the Office of the Comptroller of the Currency (OCC), representatives of industry trade groups, and several academic experts.

We also reviewed legislative proposals, congressional hearings, and reports by federal agencies. In addition, we analyzed data from commercial banks' reports of condition and income (call reports) and quarterly financial reports for savings and loan institutions. Finally, we made extensive use of information developed from our financial audits of FDIC and FSLIC and other assignments analyzing the condition of the thrift and commercial banking sectors. A listing of these sources appears at the end of this report.

Because our review focused on deposit insurance policies, we have not attempted to evaluate actions taken by insurance fund officials or federal regulators in particular circumstances. Nor did we analyze the condition of particular institutions or industry segments in detail. We also did not audit the accuracy of the insurance funds' calculations of liquidation and case resolution costs.

Agency Comments

FHLBB, FDIC, the Department of the Treasury, the Board of Governors of the Federal Reserve System, and NCUA provided written comments on a draft of this report. Relevant portions of their comments are presented and evaluated at the end of chapters 2 through 7. The comments are reprinted in their entirety as appendixes VIII through XII, respectively.

It is quite difficult to estimate the amount of money FSLIC will need to resolve troubled thrift institutions and to return to a solid financial footing. The principal difficulty is that the available information on the financial condition of problem institutions is not a reliable guide to the true economic value of these institutions. Nevertheless, we believe the evidence is clear that FSLIC does not have enough money to pay for insurance losses and to establish the level of reserves that will be necessary to enable it to function effectively as an insurer of deposits in the future.

On the basis of our assessment of the situation, we estimate that over the next decade FSLIC will need at least $85 billion more than its anticipated revenues to resolve the cases of its problem institutions, provide for future institution failures, and establish a reserve for losses. Of this amount, about $50 billion will be needed to pay for case resolution costs in the next 3 years.

Condition of the Thrift Industry

As explained in appendix I, during this decade there has been a steady deterioration in the financial condition of the thrift industry. As shown in table 2.1, on December 31, 1987, there were 940 thrift institutions (33 percent of the industry) whose capital on a GAAP basis was below 3 percent. These institutions held $395 billion in assets, about 32 percent of the industry's total. All of these institutions can be considered problem thrifts because they operate with levels of capital that are generally recognized as inadequate.

Of the 940 institutions, 505 insolvent institutions reported $140.3 billion in assets and negative GAAP net worth of about $18 billion, or 12.83 percent of assets. Their annualized return on assets (ROA)[1] of -9.52 percent at December 1987 was so large that it resulted in a negative ROA for the entire industry. Of the 505 insolvent institutions, 205 institutions with $52 billion in assets were in FSLIC's caseload. That is, the district banks had turned these over to FSLIC for resolution because the banks believed they were incapable of being rehabilitated without FSLIC assistance.

Of the 435 institutions with GAAP capital between 0 and 3 percent, 72 institutions with $35 billion in assets were unprofitable during both 1986 and 1987. These institutions, which already had negative tangible net worth[2] of $1.3 billion (almost 4 percent of assets), appeared to be headed for insolvency on a GAAP basis in the near future.

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[1] ROA is the ratio of total net income to total assets.

Table 2.1: Insolvent and Low Net Worth FSLIC-Insured Institutions, December 31, 1987

Dollars in billions

Category of thrifts	Number of thrifts	Total assets	Tangible Net Worth
GAAP insolvent institutions			
Institutions recognized in FSLIC's caseload	205	$52	$-14.6
Other insolvent	300	88	-6.5
Total insolvent	505	$140	$-21.1
Low net worth institutions			
(0-3 percent on a GAAP basis)			
Lost money in 1986 and 1987	72	$35	$-1.3
Other low net worth	363	220	-1.1
Total low net worth	**435**	**$255**	**$-2.4**
Total	**940**	**$395**	**$-23.5**

Source FHLBB Thrift Financial Reports

If there were signs that GAAP insolvent or low net worth institutions that were unprofitable 2 years in a row were recovering, the level of concern over the condition of the industry and the implications for potential demands on FSLIC resources by so many undercapitalized institutions probably would not be so high. However, to date there is little evidence to suggest that the demands these institutions are likely to place on FSLIC will diminish.

In fact, there are more reasons than not to believe that these insolvent and low net worth, unprofitable institutions' financial condition will worsen. As a group, they continue to incur both operating losses[3] and nonoperating losses.[4] In 1987, their losses were $10 billion (see table 2.2), and losses continued in 1988. Relatively few of these institutions recover.[5] And, new problem cases have been growing at a faster rate than old ones have been recovering.

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[2] Tangible net worth is a more narrowly defined net worth measure than GAAP. Tangible net worth is GAAP net worth minus goodwill, which consists principally of the amount over book value paid by an institution to acquire other institutions and other intangible assets.

[3] Operating losses occur when interest paid on deposits and other operating expense items exceed income from investments and fees. These losses translate into reduced assets and/or rising liabilities (increased borrowing) and a worsening of the thrifts' net worth position. Operating losses can result from interest-rate spread problems that occur during periods of rising interest rates when institutions that rely on long-term fixed interest rate sources of income, such as 30-year mortgages, earn less than they must pay to obtain funds.

Table 2.2: Losses in FSLIC-Insured Problem Thrifts in 1987

Dollars in billions

	Insolvent thrifts	Low net worth thrifts that were unprofitable in both 1986 and 1987	Totals
Net (after tax) income in 1987	$-9.6	$-.4	**$-10.0**
Net operating income in 1987	-4.3	-.3	**-4.6**
Net nonoperating income in 1987	-5.3	-.1	**-5.4**

Source: FHLBB Thrift Financial Reports

In assessing the financial implications of restoring FSLIC to financial health, the extent of the potential threat that the remaining 363 low net worth thrifts pose to FSLIC, while less clear, is an extremely important factor. For this group of institutions, there was a buffer of only about $4 billion in GAAP capital supporting $220 billion in assets, and their tangible net worth deficit of $1.1 billion is cause for concern about the quality of their capital. While some of these institutions may be expected to recover on their own, others will no doubt fail or require some FSLIC assistance. If efforts are not made to control risk taking in this group, the eventual losses to FSLIC out of this poorly capitalized group could become quite large.

Estimation Difficulties

A number of problems prevented us from precisely estimating the cost to FSLIC of fully resolving the problems of distressed thrifts.

- The ultimate cost depends upon many factors that are either beyond the control of the insurance funds or subject to future policy and management decisions. These factors include the future state of the national economy and of regions and sectors within the economy, interest rates, competition within the financial services industry, and the timing of actions taken to resolve cases. For example, experience suggests that the economy is likely to experience a recession at some time in the next 10 years, but it is difficult to predict when and how severe it will be and how well financial institutions will withstand it. Therefore, while it is reasonable to expect economic conditions in particular regions of the country to change, there is no assurance that the changes will be for the better.

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[4] Nonoperating losses are also indicative of the poor prospects for recovery of problem thrifts. These losses, which consist almost entirely of losses on the sale of assets and the provision for losses for non-earning assets, reveal the extent of asset quality problems in thrift's portfolios. Unlike interest-rate spread problems, which may ease if interest rates fall or if thrifts take steps to reduce interest-rate risk, bad assets have little potential for recovery. Unless the underlying factors, such as adverse economic conditions or poor management, that contributed to the asset quality problems improve, thrifts' assets may deteriorate even further and the ultimate cost of the resolution borne by FSLIC will continue to grow.

[5] See pp. 109-110.

- Allowing insolvent institutions to remain open creates an incentive for managers of insolvent and undercapitalized institutions to gamble by investing in high-risk, high-return assets, which generate above average profits if a high return is realized but additional losses that subsequently accrue to FSLIC if the return is not realized.[1]
- It is difficult to decide which inadequately capitalized institutions represent cases that FSLIC must resolve. Unfortunately, accounting information drawn from the reports these institutions file (call reports) with FHLBB provide only general guidance as to the condition of these institutions. Call report information tends to understate problems because this information is based on historical cost rather than current market values.
- Institutions are reluctant to write off bad loans and investments, and the inability to generate operating income can be masked by gimmicks, such as selling the better assets on which capital gains can be realized, to boost their apparent profitability. The true financial condition of the institutions cannot be determined without a very detailed examination of the institutions' assets and accounting records.
- FSLIC's past experience does not provide a clear picture of losses that can be expected from resolving problem thrift cases. FSLIC resolution costs vary greatly from case to case, but the average costs FSLIC has incurred in resolving cases have risen sharply in recent years.

In 1982, FSLIC's average loss ratio in resolving cases (expressed as a percent of assets) was 4.2 percent. In 1986 the loss ratio averaged about 15 percent and in 1987 it soared to nearly 41 percent. For the cases resolved through the end of September 1988, the loss factor averaged 61 percent of assets. At face value, this trend in loss ratios on case resolutions is very disturbing. But it is not obvious how this trend should be interpreted in trying to estimate losses in the future. For example, if FSLIC has been acting on its worst cases, the trend might be expected to reverse. On the other hand, the condition of many insolvent institutions can be expected to deteriorate with the passage of time, and instead of acting on the worst cases, FSLIC may have been acting on cases that, on average, were more attractive to outside investors, and thus easier to resolve.

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[1] For additional discussion, see appendix III.

- Finally, some of the merger actions taken by FSLIC have not resulted in full resolution of the problems, making reliance on FSLIC's estimates of resolution costs problematic. For example, four institutions that acquired failed thrifts with FSLIC assistance during 1987 had negative tangible net worth at the end of the year.[7] Furthermore, FSLIC's resolution of problem Southwest thrifts has not completely recognized and paid for the losses in these institutions. Instead, a series of guarantees on acquired assets in institutions that remain thinly capitalized has exposed FSLIC to losses in the future.

Analysis of FSLIC's Cash Flow Projection

In the summer and fall of 1988 the Bank Board had a goal of resolving problem institutions at a rate of one per week in addition to resolving more than 140 institutions in the Southwest under what is known as the Southwest Plan. All told, FSLIC said it would resolve 259 cases in 1988 and 1989. In 1988, as of September 30, FSLIC had already acted on 124 institutions, with assets of about $33 billion. FSLIC estimated it would take up to the end of fiscal year 1992 to complete action on the balance of the 505 GAAP insolvent institutions.

To determine the net amount of money FSLIC would have available to pay for insurance fund losses through 1998, we analyzed the FSLIC cash flow projection for fiscal years 1988 through 1998 that FHLBB presented to Congress July 7, 1988. This was the latest projection available at the time we did our study. Since July, FHLBB has increased its estimates of insurance losses and is preparing a revised forecast that will cover fiscal years 1989 through 1999. We believe, however, the July forecast still provides a reasonable basis for our analysis. Our analysis depends principally on a number of items that affect FSLIC's revenues over the next decade that are not likely to be materially affected by the forthcoming revision. These items include premiums; interest on reserves; commitments that were entered into prior to January 1, 1988; and the financing characteristics of the $10.8 billion recapitalization bonds. Also, our analysis does not concentrate on exact year-by-year cash flows that are essential for assessing FSLIC's liquidity situation and that could be more affected by a revised forecast.

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[7] Wolf statement, p. 6.

In our analysis, we made a number of adjustments to convert FSLIC's presentation from a fiscal year to a calendar year basis so that it would tie into December 31, 1987, audited financial statement data.[a] We also converted FSLIC's presentation into terms that show net insurance losses more clearly. Our summary of FSLIC's financial forecast is presented in table 2.3.

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[a] We did not have a basis for adjusting some line items which are relatively small such as "miscellaneous income: and "administrative, nonadministrative, and other expenses." For these items we used the fiscal year figure from the July 7, 1988 FSLIC cash flow projection.

Table 2.3: FSLIC's Estimate in July 1988 of Funds Available to Pay Insurance Losses: 1988 Through 1998[a]

Dollars in billions		
Money Available for Insurance Fund Operations:		
Premiums:		
Regular[b]	$13.0	
Special assessment[b]	19.4	
Total		**$32.4**
Recapitalization proceeds		9.6
Recoveries from resolutions that occurred prior to 1988		4.8
Interest on investments		1.2
Miscellaneous income[c]		3.2
Decrease in cash balance		2.8
Total money available:		**$54.0**
Anticipated Expenses other than those directly incurred in case resolution actions occurring after January 1, 1988:		
Administrative, non-administrative, and other operating expenses[d]		2.7
Interest on recapitalization bonds[b]		9.6
Repayment of secondary reserve[b]		0.8
Principal and interest on notes issued before 1988		5.8
Total anticipated expenses:		**$18.9**
Funds available to pay case resolution expenses:[e]		$35.1
Interest on notes issued after January 1, 1988, to resolve cases		$7.6
Funds available to pay insurance losses on cases acted on after January 1, 1988[f]		$27.5

[a] On July 7, 1988, FSLIC submitted a budget outlay estimate covering the 11-year period of fiscal years 1988 through 1998. This table is based on this submission but covers the 11-year calendar year period from January 1, 1988, to December 31, 1998. We used this period so we could use FSLIC's audited financial statements of December 31, 1987, as a starting point.

Because the table is built up from budget estimates, the amounts in the table represent the sum of estimated values in each of the years covered by the projection; these amounts are not on a present value basis.

[b] The $9.6 billion associated with the payment of interest on the FICO recapitalization bonds and the $.8 billion associated with the repayment of secondary reserves are actually deducted from FSLIC's regular and special premium income, respectively, before FSLIC receives its money. We have shown the FICO bond interest and secondary reserve repayment as expenses so that the table more clearly shows the total amount of premiums expected to be paid by the thrift industry. The secondary reserve was the equity of certain institutions in FSLIC based on prepaid premiums and related interest not yet paid to these institutions. Because FSLIC suffered losses during calendar year 1986 in excess of all of its reserves, the secondary reserve was eliminated in order to reduce losses to the primary reserve. Title III Section 307 of the Competitive Equality Banking Act of 1987 (CEBA) authorizes insured institutions to offset against future special assessment premiums their pro rata share of $823.7 million that was previously in the secondary reserve.

[c] Includes recoveries from assets acquired before 1988, income from capital certificates FSLIC purchased from institutions to supplement their net worth, and other miscellaneous income.

[d] Includes administrative expenses, liquidation and non-administrative expenses, other operating expenses, and expenses to acquire certain assets from insured institutions.

[e] The estimate of $35.1 billion is the net amount of funds available to pay for insurance losses and associated financing costs after subtracting other anticipated expenses from the total revenue available to the fund. The estimated funds available to pay for insurance losses is net of the proceeds from liquidating assets acquired in cases acted on after January 1, 1988.

The availability of these funds is spread over the 11-year period corresponding to the timing of revenues. FSLIC expects to use notes as part of its case resolution actions so that it can resolve problems more quickly. FSLIC's forecast indicates that it will finance about 41 percent of its outlays for case resolutions with notes and that the notes will result in interest expense of $7.6 billion during the 11-year period. Paying these interest costs lowers the amount of insurance losses FSLIC will be able to absorb to $27.5 billion.

[f] The $27.5 billion can be used to make cash payments, pay the principal on notes, or pay the amount due on guarantees. FSLIC's projection assumed that the principal on all notes issued would be paid off by year-end 1998, and the projection made no explicit mention of guarantees extending beyond that date.

Of the $54 billion in funds that FSLIC said it would have available, about $32 billion is from premiums—$13 billion is from regular premiums and $19.4 billion from continuing the special premium of 1/8 of 1 percent of total deposits through 1998.[g] In addition, $9.6 billion is anticipated from the sale of recapitalization bonds. With the funds available, FSLIC's projection shows it would be able to absorb insurance losses of $27.5 billion, net of recoveries on assets in receiverships, through 1998. FSLIC's cash flow is based on the assumption that almost all of the cases can be resolved by assisted mergers rather than liquidations. In this projection FSLIC expected to issue $13.8 billion in notes and to pay off all of them by the end of 1998.

Besides the insurance losses, the other major expense category FSLIC faces is interest and the repayment of prior obligations. The FSLIC projection shows that interest costs (plus repayment of principal on $4.9 billion in notes issued before 1988) will claim about $23 billion of its resources. The interest on issued recapitalization bonds is in essence paid by pledging a portion of FSLIC's regular and special premium income. By the time the entire $10.8 billion in recapitalization bonds has been issued, FSLIC expects the interest payments on these bonds to exceed $1 billion per year, and over the next 11 years to total $9.6 billion. In addition, the FSLIC forecast indicated that the $13.8 billion in notes it plans to issue in resolving institutions between January 1, 1988, and December 31, 1993, will result in interest costs of $7.6 billion through 1998.[10]

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[g] FHLBB officials have said that the special premium may have to be continued for at least 30 years.

Our Assessment

The FSLIC budget projection is based on several optimistic assumptions and could be upset by any one of several occurrences affecting revenues, expenses, or both.

Looking first at revenue, FSLIC's assumption of a 7-percent growth in deposits is reasonable by historical standards. The projected growth in FSLIC deposits is in line with a reasonable forecast of the growth in nominal GNP, assuming no recession. However, some of the growth in FSLIC-insured deposits that has occurred in the past can be attributable to the high rates of interest paid by insolvent or undercapitalized thrifts. This contributing factor to growth in FSLIC-insured institutions should decline as problem cases are resolved.

In addition, premium income could decline if institutions are allowed to withdraw from FSLIC in favor of FDIC or if the public decided to place a greater portion of its deposits in FDIC-insured institutions.[11] If the rate of growth in FSLIC deposits over the decade averaged 3 percent rather than 7 percent, FSLIC's premium revenues would be about $7 billion lower over the decade than the amount shown in table 2.3.

Insurance losses and interest payments represent the two key elements of FSLIC's expenses. As of September 30, 1988, FSLIC had acted on 122 institutions with about $32 billion in assets. Measured by assets, FSLIC had acted on 23 percent of all insolvent institutions that existed at the end of 1987. The expected cost to the fund of those actions is about

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[10] The amount of these notes ($13 billion) is not identified in table 2.3. The projection assumes they would be paid off before the end of the period.

[11] Under CEBA, institutions that meet FDIC's insurance standards can leave FSLIC for FDIC if they pay FSLIC an exit fee equal to twice the then prevailing regular and special premium. In 1988 this exit fee would have been about .41 percent of total deposits. This exit fee goes to FICO. Since the payment of exit fees to FICO reduces the need for a portion of FSLIC's premium income to be paid to FICO, we have made no provision for reflecting exit fees in our estimate of FSLIC revenues. If the special premium of 1/8 of 1 percent deposits is to be continued indefinitely, there will be added incentive for institutions to apply to leave FSLIC. CEBA imposed a moratorium on transfers that has been extended to August 1989.

The public may determine that it is more appropriate to place money in FDIC-insured rather than FSLIC-insured institutions if it perceives that there is a problem with FSLIC or if higher insurance premiums or regulatory restrictions reduce the rate of interest FSLIC-insured institutions could pay on deposits relative to FDIC-insured institutions.

$19.8 billion—about 72 percent of the $27.5 billion for insurance losses included in FSLIC's cash flow projection.[12]

FSLIC actions taken through September 30, 1988, left only about $8 billion to finance losses for actions on all of the remaining insolvent institutions having about $107 billion in assets. Resolution costs per dollar of assets in insolvent institutions would thus have to average about 7 percent in order for FSLIC's $27.5 billion insurance loss estimate to be borne out. This rate of losses on assets is considerably lower than the loss rate of about 61 percent which FSLIC experienced in resolution actions in 1988 through September.

As for interest expenses, in the first 9 months of 1988, FSLIC had issued about $10 billion in notes with maturities ranging from 6 months to 15 years, and it anticipated issuing more notes in its future actions. Because most of the notes it has been issuing are for 10 years and at a rate (approximately 9 percent) higher than in the July 1988 forecast, interest costs over the next decade are likely to be higher than those contained in the forecast.

A detailed analysis of FSLIC's near-term liquidity situation was outside the scope of our work on this assignment. However, we are concerned about the liquidity implications of FSLIC's projections. FSLIC assumes that it will be able to operate throughout the decade with a cash balance that averages about $1 billion. Such a small cash balance provides little room for flexibility given the uncertainties associated with FSLIC's operations. At the present time, FSLIC is acting on cases at a rate that cannot be sustained within its available resources, paying for its actions mostly with notes and guarantees that defer cash outlays. At the same time, there are elements in FSLIC's cash flow that it cannot fully control, such as the proceeds from asset sales or the timing of payments on certain guarantees. Although FSLIC has options for borrowing in an emergency situation, use of these options could heighten public anxiety over FSLIC's condition.

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[12] Because of FSLIC's shortage of cash, most of these actions were accomplished with notes and guarantees that defer cash outlays. The FSLIC projection assumed that these obligations would, however, be paid off by 1998.

Estimate of FSLIC's Additional Funding Need

We estimate that FSLIC's projection of the resources available to it through 1998 falls short of what the fund will need to become financially sound.

- Even if FSLIC's revenue assumptions are realized, we estimate that over the 3 years 1989, 1990, and 1991, FSLIC will need additional funds for insurance losses on presently insolvent or undercapitalized institutions amounting to at least $50 billion.
- In addition, we estimate FSLIC will need $5 billion for future insurance losses related to institutions that are not now severe problem cases, $10 billion to cover financing costs for case resolutions, and $20 billion to establish adequate insurance fund reserves.
- In total, therefore, we estimate that to be restored to sound financial condition FSLIC will need at least $85 billion over the next decade in addition to the amounts included in FSLIC's cash flow projection. The basis for these estimates is described in the following sections.

Insurance Losses in Presently Identified Problem Institutions

The largest single increase in our estimate over that made by FSLIC involves the additional losses in resolving cases of presently identified problem thrifts. In view of the uncertainties associated with the cost of resolving problem institutions, we adopted a building block approach for estimating FSLIC's case resolution costs. We separately estimated the cost of resolving FSLIC's caseload, other insolvent institutions, and low net worth institutions. We estimate that it could cost at least $77 billion to fully resolve insolvent and low net worth institutions over the next 3 years—1989, 1990, and 1991. The amount not provided for in FSLIC's projection is about $50 billion.[11] (See table 2.4.)

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[11] In interpreting these numbers, it should be recognized that we have made an assumption about how FSLIC resolves cases that minimizes the calculation of FSLIC's need for cash. We have assumed that at the time it takes actions to resolve cases, FSLIC will pay out cash or notes only in the amount of the full value of the economic loss. By making this assumption, which reduces the amount of cash flowing into and out of FSLIC, it is easier to focus on the implications of financing the underlying economic loss that FSLIC faces. In reality, when FSLIC implements a merger or liquidation, it often makes an outlay in the form of cash or notes which is larger than the expected loss, and then recovers a portion of the outlay when it sells acquired assets or obtains agreed-upon future payments from the acquirer. When the liquidation of assets is completed or all future payments made, the net loss to the fund (on a present value basis) is the same as the loss amounts in our estimates.

Table 2.4: Estimated Costs for Full Resolution of Problem Thrift Cases[a]

Dollars in billions

Category	
FSLIC caseload (205 cases with $52 billion in assets)[b]	$26.7
Other insolvent institutions (300 cases with $88 billion in assets)[c]	39.9
Low net worth institutions that lost money in 1986 and 1987 (72 cases with $35 billion in assets)[d]	10.5
Total cost of resolution	**77.1**
Less funds available to pay for losses bases on FSLIC's forecast (from Table 2.3)	27.5
Net additional cost	**$49.6**

[a] Estimates assume that actions to resolve the cases of these institutions would be taken within the next 3 years—i.e., by the end of 1991.

[b] Our estimate assumes that the overall cost of resolving FSLIC's caseload will be significantly higher than FSLIC's original estimate and will average 51 percent of assets. This cost of $26.7 billion was calculated by applying FSLIC's recent loss experience of 61 percent of assets to $19.7 billion in caseload institutions acted on through the end of September and adding to it a loss of 45.3 percent on the remaining $32.4 billion in assets. We used 45.3 percent of assets because it is the midpoint of FSLIC's recent loss ratio of 61 percent and the approximately 30 percent of assets associated with FDIC's loss experience for resolving insolvent commercial banks with assets of less than $500 million during 1985, 1986, and 1987.

[c] Our estimate is based on a loss of 45.3 percent of assets. The basis for this percentage is the same as that stated in note b.

[d] Our estimate assumes that all these institutions will become insolvent and thus require FSLIC resolution. We assume that FSLIC will resolve these cases closer to the point at which they enter insolvency than has occurred in the past. To calculate our estimate we used FDIC's average loss ratio for cases of commercial banks with assets less than $500 million. This ratio was approximately 30 percent of assets for the 3 years 1985, 1986 and 1987.

Costs of Resolving FSLIC's Caseload

The best information available on the costs for resolving problem thrifts is that concerning the 205 institutions in the FSLIC caseload. Cases are referred to FSLIC only when FHLBB officials have determined that it is *not* possible to resolve the problems through supervised work out or unassisted merger and, thus, some FSLIC assistance is inevitable.

The financial statements of institutions in FSLIC's caseload are more likely to closely approximate underlying market value than the financial statements of other insolvent or inadequately capitalized institutions because the caseload institutions have been more carefully scrutinized by supervising officials. However, the losses FSLIC has incurred in resolving these cases have thus far exceeded by a considerable amount the losses FSLIC had estimated from the information available to supervisory officials.

In its 1987 financial statement, FSLIC recognized a liability of $17.4 billion for the expected cost of resolving the 205 institutions in its caseload and several other institutions.[14] The amount associated with institutions in the caseload represented an average loss of about 31 percent of the $52 billion in assets in those institutions.

In auditing FSLIC's financial statements, we determined that FSLIC's estimate was reasonable on the basis of information available at that time. We note, however, that the losses incurred by FSLIC in 1988 through September 30 are, on average, almost twice the estimated 31 percent of assets.[15] FSLIC says that its costs have been substantially greater than anticipated in its 1987 financial statement primarily because institutions continued to incur losses between the time of the estimate and the time of closing, and the assets in institutions FSLIC has closed were found to be more seriously impaired than originally anticipated.

If FSLIC has been acting on the worst institutions in its caseload, as the Bank Board has often suggested, FSLIC's costs for the remaining institutions in its caseload may not be as high as the costs in 1988 FSLIC incurred through September. In making our estimates for FSLIC, we have also been mindful of FDIC's recent expenses in resolving bank failures. In 1985, 1986, and 1987, FDIC's losses in acting on cases of commerical banks with less than $500 million in assets have averaged 20, 36, and 32 percent of assets, respectively, with an overall average for the period of 29.4 percent. We think it unlikely that FSLIC's loss percentages could fall significantly below the approximately 30 percent of assets that FDIC has been experiencing in cases other than large commercial banks.[16] FSLIC will be acting upon institutions that have been GAAP insolvent for some time but which the FHLBB or state charterer have permitted to stay open. Such institutions are likely to have larger losses than banks that FDIC is resolving because FDIC-insured institutions have generally been acted upon closer to the point of their insolvency. We also note that FSLIC's actual loss experience in 1988 (through September 30) for cases not in the Southwest Plan was about 45 percent of assets. Based on the above case resolutions, we assume that the average loss percentage FSLIC will incur on the remaining institutions in its caseload is about 45 percent of assets—the midpoint of FDIC's loss experience of 30 percent and FSLIC's 1988 loss experience of 61 percent of assets through the end of September.[17] Thus, we estimate that the costs of fully resolving FSLIC's total caseload will be about $27 billion.

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[14] In FSLIC's 1987 financial statement, as noted above, FSLIC included a provision for loss of $17.4 billion primarily associated with the 205 institutions with assets of $52 billion in FSLIC's caseload. The $17.4 billion included about $1.3 billion associated with other unspecified institutions that FSLIC expected to resolve in 1988, but that were not part of the caseload.

[15] In 1988, through the end of September, 40 of the 124 cases FSLIC had acted on were institutions with assets of $12.9 billion that were not part of its caseload at December 31, 1987. Most of these institutions were included in mergers in which costs are not allocated to each institution. Because of the difficulty in precisely determining the costs of these 40 institutions, we have included their cost in our calculations of the average loss percentage in FSLIC's caseload. We have not, however, included the assets of these noncaseload institutions in our calculations of the percentage of caseload institutions that have been resolved.

[16] FDIC has experienced a loss ratio of about 10 percent of assets in resolving the cases of commercial banks with over $500 million in assets. We believe FDIC's 30-percent loss experience for commercial banks under $500 million is relevent for estimating FSLIC's potential loss, because the average asset size of the 505 thrifts that were insolvent as of December 31, 1987, was $227 million.

Cost of Resolving Cases of the Other Insolvent Institutions

There is no way to know how the true condition of the other 300 insolvent institutions compares with the cases already in the FSLIC caseload. If the supervisory system is working as it should, the FSLIC cases should be worse than those that have not been referred. However, both the supervisory system and FSLIC's ability to resolve cases have been severely strained. On the basis of information currently available, we think the distinction between cases that are, and are not, in FSLIC's caseload cannot be relied upon in making judgments about the condition of other insolvent thrifts.[18]

We estimate that FSLIC will incur costs of nearly $40 billion to resolve these institutions on the basis of a loss percentage of about 45 percent of assets. This percentage is the midpoint of FDIC's 30-percent loss experience for cases of commercial banks with less than $500 million in assets and FSLIC's actual loss experience in 1988 of 61 percent of assets. Our estimate thus assumes that the insolvent institutions that are not in FSLIC's supervisory caseload are on average in about the same condition as those remaining in the caseload.

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[17] As noted in chapter 4, some FSLIC actions have not fully resolved problem cases, and FSLIC's cost calculations do not reflect tax losses to the Treasury that result from FSLIC's assistance agreements. Our use of actual FSLIC loss ratios thus may tend to understate the full resolution costs.

[18] In its 1987 financial statements, FSLIC recognized that it would likely incur some losses for the 300 insolvent institutions not already in its caseload. FSLIC estimated losses equal to the tangible net worth deficit, about $5.3 billion, might be expected for the 300 insolvent institutions not yet included in its caseload. The $5.3 billion would be, however, a loss of only 6 percent on these institutions.

Costs of Resolving Insolvencies That May Occur Among Presently Identified Low Net Worth Institutions

We believe it is reasonable to expect the low net worth institutions that have been unprofitable for the last 2 years to continue incurring losses and become insolvent. We have assumed that FSLIC will act on these cases at a point close to insolvency and for this reason will incur resolution costs similar to those that FDIC incurs in acting on commercial banks with less than $500 million in assets. We therefore applied a loss estimate of 30 percent to the $35 billion in assets in these 72 institutions. Thus, our loss estimate for these institutions amounts to $10.5 billion.

Financing Costs

Our $50 billion estimate of FSLIC's additional funding requirement represents money needed to pay the costs involved in taking action during 1989, 1990, and 1991 to fully resolve the cases of institutions that are already insolvent or will be during that time period. The potential for additional interest expense arises if means are used to borrow some or all of the $50 billion or to defer cash outlays through the issuance of notes.[19] The amount of interest that would be paid can vary according to the length of time and interest rate associated with different borrowing options.

We estimate that FSLIC's financing costs will be about $10 billion more than the amount FSLIC included in its estimate.[20] If present policies of financing costs by issuing notes or by using other forms of borrowing (including guarantees) continue, a significant increase in interest expenses could be incurred. For example, if all of the $50 billion were obtained by a long-term borrowing arrangement similar to the existing $10.8 billion recapitalization program, additional interest costs of about $40 billion would be incurred. Our $10 billion estimate assumes that half of the $50 billion in additional insurance losses we anticipate would be paid for with the type of notes FSLIC used in its July 1988 projection—5-year notes that carry an 8-percent rate of interest. If notes or other borrowing were to have a longer maturity, interest costs would increase. And, if principal repayments are delayed beyond 1998, interest and principal payments would carry over to 1998 and beyond and would represent a claim on future FSLIC premium income. It should be noted that interest payments on the 30-year recapitalization bonds already represent a significant claim on FSLIC premium revenue well beyond 1998.

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[19] Although not counted by FSLIC as an explicit interest expense, a comparable cost is implicitly involved if cash outlays are deferred by guarantees paid at a later date.

[20] If FSLIC obtained the additional funds needed to resolve the cases of its problem thrifts from sources that do not involve borrowing, FSLIC would not have to pay additional interest expenses on the $50 billion.

Future Insurance Losses

FSLIC has not included any estimate for funding institution failures within the 1988 to 1998 time frame beyond those which were already insolvent as of December 31, 1987. Our estimate of FSLIC losses has already included an amount for resolving the problems of the more troubled low net worth institutions—72 that had lost money 2 years in a row. We also believe it is reasonable, in developing funding estimates, to plan for some additional losses from the 2,570 remaining institutions insured by FSLIC, 363 of which have less than 3 percent GAAP net worth. Although we have no empirical basis for estimating such losses, we have included $5 billion in our funding estimate to formally recognize the potential for losses from these institutions. Losses could easily become larger than this estimate should a recession or periods of high interest rates occur or if no improvements are made in the ability of the deposit insurance system to manage its exposure to possible losses. These improvements, which have particular relevance for the 363 low net worth institutions that had $220 billion in assets, are discussed in chapter 5.

Reserves

In addition to the amounts needed to cover losses, FSLIC will also need to build reserves if it is to return to financial health. The FSLIC projection makes no provision for this. To estimate the reserve amount, we have applied a factor of 1.1 percent of projected thrift industry insured deposits as of 1998. This percentage is consistent with the standard for minimum insurance fund reserves contained in deposit insurance legislation. The estimate of the level of insured deposits is based on (1) FSLIC's assumptions about deposit growth[11] and (2) an assumption that the current ratio of insured deposits to total deposits (about 92 percent) will be maintained over the decade. The result is the need for $20 billion to rebuild reserves to the target level.

Updated Outlook as of December 31, 1988

In the last quarter of 1988, FSLIC acted on a total of 101 cases at a total cost to the fund (in present value terms) of $19 billion. Most of this flurry of activity represented assisted merger deals, which are described more fully in chapter 4. In total in 1988, FSLIC acted on 223 institutions at a total cost to the fund (on a present value basis) of $38.6 billion. FSLIC activity during 1988 is summarized in table 2.5.

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[11] If FSLIC's projected deposit growth rate is not realized, the amount of reserves needed (calculated as a percent of deposits) would be reduced. However, as noted above, the lower growth rate would also translate into lower premium income. The need for revenue to replace projected premium income would more than offset the savings that would be associated with a lower reserve requirement.

Table 2.5: Summary of FSLIC Actions During 1988

Dollars in billions

Categories of Thrifts	Number of thrifts	Assets	FSLIC's Estimated costs on a present value basis	Cost of assets
Institutions acted on 1/1/88 - 9/30/88				
Insolvent at 12/31/87	115	$29.4		
Other institutions	7	2.6		
Total	**122**	**$31.9**	**$19.7**	**61.5%**
Institutions acted on 10/1/88-12/31/88				
Insolvent at 9/30/88	94	41.1		
Other institutions except for American S&L	6	7.1		
Subtotal	**100**	**$48.2**	**$17.3**	**35.9%**
American S&L (Financial Corp of America)	1	30.1	1.7	5.6%
Total	**101**	**$78.3**	**$19.0**	**24.3%**
Grand Total	**223**	**$110.2**	**$38.6**	**35.0%**

Sources: Preliminary analysis by GAO based on FHLBB data and Thrift Financial Reports.

As of December 31, 1988, we estimate that there were still at least 338 insolvent thrifts with about $100 billion in assets whose cases need to be resolved. However, the number of insolvent institutions that FSLIC must resolve is a moving target. Our estimate is probably understated because it does not include institutions that may have become insolvent during the last quarter of the year. A summary of the number of insolvent thrifts at selected points from December 31, 1987, to December 31, 1988, is shown in table 2.6.

Table 2.6: Insolvent Thrifts at Different Times: December 31, 1987 to December 31, 1988

Dollars in billions

Time	**Number of Thrifts**	**Assets**
December 31, 1987	505	$140.3
September 30, 1988	432	$138.2
less. FSLIC 4th quarter actions involving institutions that were insolvent at 9/30/88	94	41.1
December 31, 1988[a]	338	$97.1

[a] Assumes no new insolvent institutions during the 4th quarter of 1988.

Sources: Preliminary analysis by GAO based on FHLBB data and Thrift Financial Reports.

Earlier in the chapter we estimated FSLIC's additional needs for insurance expenses at $60 billion — $50 billion for insurance losses and $10 billion for interest. As a result of the activity that occurred in 1988, it is useful to divide the $60 billion another way. Part of the $60 billion is needed to pay for unfunded costs of activity taken in 1988. The other part is needed to resolve the remaining insolvent institutions.

In the 223 cases that were acted on in 1988, we estimate that FSLIC will need a total of about $60 billion through 1998 to pay for all of the expenses associated with those actions. These expenses include repayment of principal on notes, interest payments, and payment of all guarantees that are required to fully resolve the cases under the deals that have been made. However as things stand now, FSLIC will only have about $34 billion in revenue from regular and special premiums and from the remainder of the borrowing through FICO. The result is that we estimate FSLIC will need another $26 billion to pay for the costs that cannot be funded from FSLIC's basic revenue sources. Table 2.7 summarizes our estimate of FSLIC's need for funds if it is to pay for all of the costs of its 1988 actions by the end of 1998.

Table 2.7: Estimated Funding Shortfall for FSLIC Actions Taken in 1988

Dollars in billions

Category	Present Value Cost to FSLIC	Cost to FSLIC Through 1988 on Cash Basis [a]
Total funds needed Southwest plan deals	$24.6	$44.2[b]
Other case resolutions	14.0	15.8[c]
Total	**38.6**	**60.0**
Total funds available (Deduct)		34.0[d]
Funding shortfall		$26.0

[a] Assumes that all obligations are paid for by 1998.

[b] The major components are principal payments on notes ($9.2 billion), interest on notes ($8.6 billion), capital loss coverage ($15.6 billion) and yield subsidy payments ($10.9) billion). These deals are explained in more detail in chapter 4.

[c] GAO estimate.

[d] Calculated from table 2.3. The amount ($35.1 billion) shown in that Table for funds available to pay case resolution expenses has been reduced by about $1 billion to pay additional interest expenses on FICO borrowing, which is expected to occur at a faster pace than was assumed in FSLIC's July 1988 cash flow projection.

Source: FHLBB and preliminary GAO estimates.

Our overall estimate of FSLIC's need for additional funds to pay for insurance losses and interest is $60 billion, and we have just shown that $26 billion will be needed to pay for actions already taken in 1988. This leaves an estimated $34 billion to pay for insurance losses and financing costs associated with resolving the remaining 338 insolvent institutions.

We are by no means sure that this will be enough money to resolve the rest of the insolvent thrifts, but at this time we have no basis for revising this estimate. If insurance losses in the remaining cases turn out to be lower than those incurred in 1988, the $34 billion could prove to be sufficient. There are, however, two factors that could well push the cost estimate higher. One is that additional problem institutions are likely to become insolvent in the near future. As of September 30, 1988, there were 154 thrifts with $166 billion in assets that were solvent on a GAAP basis but which already had negative tangible net worth. In addition, cash needs will increase if FSLIC continues to resolve cases with deals that involve notes and guarantees and little up-front cash.

Summary

Our estimate that FSLIC needs at least an additional $85 billion to pay for insurance losses and restore adequate reserves is summarized in table 2.8. Our estimate assumes that approximately $50 billion will be needed by 1991. With this funding, a significant proportion of the insurance losses can be paid with cash, which will reduce the ultimate cost to the government.

Table 2.8: Summary of Estimated Funds Needed by FSLIC Through 1998 in Excess of Those Anticipated in FSLIC's July 7, 1988, Projection

Dollars in billions

Category	Amount
Unfunded Resolution Costs From 1988 Actions	$26
Amount Needed for Remaining Insolvent Cases	34
Amount Needed for Future Losses	5
Amount Needed for Adequate Reserve	20
Total	**$85**

If there were a dramatic turnaround in the regional economies in which many problem thrifts are located, the amount of money required by FSLIC could conceivably turn out to be less than the $85 billion we have estimated. However, we believe that on balance, it is likely that more than the $85 billion may be needed. For example, more than $85 billion will be needed if

- The growth of deposits in the thrift industry slows down.
- Interest rates in the economy increase.
- A recession or additional regional economic problems occur.
- Average loss ratios incurred are higher than those used in our cost estimates. (Our cost estimates, based largely on FSLIC's actual experience, make no explicit adjustment for continued losses until cases can be resolved.)
- Additional insolvencies occur.
- More deals are made that rely heavily on notes and guarantees to defer cash outlays.

Conclusion

If FSLIC is to return to financial soundness, it will need funds to pay for actions it has already taken, resolve its current backlog of problem thrifts, pay for the additional interest expense associated with financing its case resolution operations, and establish adequate insurance fund reserves. On the basis of FSLIC's projection of its available resources over the next 11 years, we estimate that FSLIC faces a funding shortfall of at least $85 billion. This estimate assumes that permanent action is taken to resolve insolvent cases by the end of 1991.

Agency Comments and Our Evaluation

NCUA, FDIC, and FHLBB discussed our estimate of the size of FSLIC's funding need in their comment letters. NCUA said that our study parallels its research that substantial funding must be provided to resolve what it termed as "this massive problem in the S&L industry."

FDIC generally agreed with our estimate of the cost of resolving the S&L industry's problems and with our conclusion that the size of the problem is well beyond FSLIC's available resources. FDIC agreed that it may be appropriate to use FDIC's 30 percent loss to asset ratio in estimating S&L failure costs but asked that we clarify our explanation of the 30 percent loss rate since it applies to resolving bank failures having less than $500 million in assets. (FDIC's loss ratio in resolving larger bank failures has been about 10 percent.) We revised the notes in Table 2.4 and amended the explanation of our method for estimating FSLIC's potential losses (pages 35 and 36) to clarify the meaning of FDIC's 30 percent loss rate. We also explained on page 36 why, in our judgment, FDIC's 30 percent loss experience is relevent for estimating potential FSLIC losses.

FHLBB concurred with our view that FSLIC will require more funds than are anticipated over the next 10 years noting that it has made cash-flow projections showing a need to extend the special assessment for at least 30 years, even though it recognizes that such an extension is not realistic. FHLBB said it was premature to comment directly on our $85 billion estimate because the cost of resolving remaining problems is currently under reassessment.

Chapter 3

Why FSLIC's Problems Should Be Resolved as Soon as Possible

The additional money FSLIC needs over the next 10 years to close insolvent institutions and to establish adequate reserves—at least $85 billion—is quite large. With so many other problems facing the country, the question arises as to how important it is to deal with FSLIC now. Is there not some prospect that insolvent institutions can cure themselves? Why not work within the constraints of FSLIC's revenue stream to resolve cases even if it means that many years must pass before the problem is finally resolved? What are the risks of not moving quickly?

FSLIC thus far has been able to function on the basis of ad hoc changes in operating procedures and in funding sources. As with some of the insolvent thrifts it insures, FSLIC appears to have the ability to operate so long as people remain confident that the federal government stands behind it. There are, however, a number of compelling reasons for moving as quickly as possible to do more than the minimum necessary to keep FSLIC operating from year to year.

- The problem is getting worse.
- A swiftly implemented comprehensive approach can save money and minimize the impact on the budget deficit.
- FSLIC's insolvency is damaging the U.S. financial system.
- Failure to deal quickly and effectively with FSLIC's problems may make it harder to ensure the soundness of FDIC.

The Problem Is Getting Worse

The losses insolvent and undercapitalized thrift institutions experienced in 1987 and 1988 represent a continuation of the industry's deterioration that has been occurring since the early 1980s. In 1987, total losses in insolvent and low net worth thrifts were accumulating at a rate of about $27 million per day. In the first quarter of 1988, these losses accumulated at a rate of about $50 million per day. The industry as a whole lost $9.4 billion in the first three quarters of 1988.

There are more reasons to believe that losses will continue as long as most insolvent thrifts remain open than there are reasons to believe that they will stop. Some of the losses reported each quarter do not affect FSLIC's eventual resolution costs because they simply represent belated recognition of losses that were incurred in the past. However, operating losses, which reflect both the lack of interest income on bad loans and cost factors, represent a dollar for dollar reduction in thrifts' net worth and an increase in FSLIC's cost of resolutions.

In addition, the reasons for current losses in insolvent thrifts are different from those of the early 1980s, when most thrift institutions were unprofitable because of the consequences of their exposure to interest-rate risk.[1] In that instance, when interest rates fell most of these institutions once again became profitable.

Now, the basic issue facing insolvent thrifts is one of asset quality. Even if there is some recovery in depressed sectors of the economy, it does not follow that problem assets will become performing ones. For example, it may take a long time for property values to return to their former levels even if economic measures such as the unemployment rate show signs of recovery. Also, interest rates could rise in the future, which would only accelerate the deterioration in already insolvent institutions.[2] Should a recession occur, this too would lead to further deterioration. Thus, a strategy that hopes for FSLIC recovery based on improvements in the economy risks greatly aggravating a problem that has already grown to serious proportions.

One of the strongest factors portending a worsening of the FSLIC situation is the harmful incentive at work in the current environment within which insured institutions operate. As noted in chapter 2, poorly capitalized and insolvent institutions have an incentive to take on additional risks because if the risks pay off, the owners win, while if the risk taking fails, the insurance fund pays most of the losses. FSLIC itself has added to the incentive problem because, on the one hand, it does not have the funds to effectively resolve all troubled institutions; and, on the other, as discussed in chapter 4 some institutions it has resolved through merger actions have not been adequately capitalized. FHLBB has, however, adopted regulations intended to permit little or no growth in the size of troubled or insolvent institutions.

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[1] Interest rate risk here refers to the way changes in rates of interest affect the interest earnings and interest expenses of a thrift or any other financial institution. In the thrift situation referred to, most thrift money was invested in fixed-rate, long-term mortgages. However, most thrift deposits were in short-term or passbook savings accounts that could be withdrawn by the depositor. To retain these deposits, thrifts had to pay rates of interest higher than they were earning on their fixed-rate assets, and consequently the thrifts lost money.

[2] Rising interest rates would tend to increase the eventual resolution cost of problem thrifts by decreasing the value of the long-term, fixed-rate mortgage assets held by such institutions. While thrifts have proportionately reduced their holdings of all mortgage-related assets and increased their holdings of adjustable rate mortgages (ARM), fixed-rate mortgage assets still continue to dominate thrift portfolios. A rising interest rate environment could be expected to exacerbate problem thrift operating losses, reactivate interest rate spread problems, and create a slowdown in the housing market. (Interest rate spread is the difference between: (1) the interest earned on mortgages and other loans and investments, and (2) the interest thrifts must pay to obtain deposits and funds from other sources.) Operating expenses and return on capital must, for the most part, be financed out of the spread.

A Comprehensive Approach to the FSLIC Problem Can Save Money and Minimize the Impact on the Budget Deficit

Although much of the uncertainty associated with the ultimate cost of resolving the FSLIC situation results from lack of good information about the true condition of problem institutions, ultimate costs also depend on policy decisions. As we have just mentioned, prompt action to fully resolve cases saves money by reducing the time available for insolvent institutions to generate additional operating losses and take new risks. Strict regulatory and supervisory controls over these institutions until their cases can be resolved can also serve to reduce operating losses and reduce opportunities for risk taking.

The need for prompt action to reduce insurance losses extends beyond the institutions that already are insolvent. At the end of 1987, there were about $255 billion of assets in thrifts that were barely solvent. Potential losses in this group must be curtailed if the cost of resolving the FSLIC situation is to be contained. Prompt case resolution, which requires adequate funding, will put pressure on institutions that are thinly capitalized and in danger of failing, but capable of surviving, to make an all-out effort to seek private capital. However, strict oversight and supervision is also needed to contain future losses among thinly capitalized institutions.

FSLIC's receipts and outlays are included in the U.S. government's budget. The costs FSLIC must sooner or later incur to resolve the cases of insolvent institutions will, therefore, eventually affect the budget deficit. By developing a comprehensive approach to the problem, FSLIC's impact on the deficit can be minimized by heading off future growth of the problem, by finding lower cost solutions, and by making provisions for revenue sources. A comprehensive approach will also result in better projections of future budget impacts and, therefore, contribute to better budget control. Currently, projection of future budget outlays associated with the FSLIC problem are highly uncertain and open-ended.

FSLIC's Insolvency Is Damaging the U.S. Financial System

FSLIC's insolvency damages the U.S. financial system in a number of ways.

- Confidence in the thrift industry and perhaps in the whole U.S. financial sector is at risk.

We pointed out in chapter 2 that FSLIC-anticipated operating throughout the next decade with a small cash balance, but that its cash needs were not entirely in its control. If the financing arrangements under which FSLIC is carrying out its functions led a significant portion of the public to doubt that FSLIC would be able to maintain its liquidity, a crisis could occur in the thrift industry.[3] If the crisis were not dealt with promptly, confidence in other financial institutions and markets could also be lost. In addition, allowing so many insolvent and severely undercapitalized institutions that FSLIC cannot close, but whose condition would further deteriorate with higher interest rates, to continue to operate jeopardizes confidence in the ability of monetary policy to act to achieve objectives such as controlling inflation.

- FSLIC's insolvency damages the economy by permitting inappropriate lending and investment decisions.

As noted above, with FSLIC insolvent and unable to close insolvent institutions, managers and owners of insolvent and weak institutions have an incentive to undertake risky but potentially highly profitable business strategies. Such behavior distorts the function of capital markets because the costs of risk bearing are not borne by those taking the risks. This interferes with the risk/return trade-off and results in an uneconomical allocation of investable funds in the economy.

- FSLIC's insolvency raises the cost of funds for all depository institutions.

The evidence suggests that insolvent and poorly capitalized thrifts have paid more than generally prevailing rates for deposits, especially in Texas.[4] This not only causes a misallocation of funds to risky institutions, but, to remain competitive, marginally healthy as well as healthy thrifts also have to offer higher rates, which increases their operating costs. This contributes to a weakening of the entire industry.

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[3] This was amply illustrated in the 1985 Ohio thrift crisis. The failure of a small government securities firm in Florida brought down Ohio thrifts with which it had financial dealings. This, in turn, helped create runs on thrifts in Ohio that were not insured by FSLIC. FSLIC is by no means in the same situation as a private insurance fund insuring state-chartered thrifts. But the combination of borrowing, notes, and guarantees FSLIC is using to meet its demands could lead fearful market participants to take actions that could disrupt market stability.

[4] See Donald J. Bisenius, An Analysis of the Proposed Capital Requirements for Thrift Institutions, Staff Study, Federal Home Loan Bank Board, Office of Policy and Economic Research August 15, 1986, pp. 66-68. According to Mr. Bert Ely, of Ely and Company, Inc., in testimony before the House Committee on Banking, Finance and Urban Affairs on May 19, 1988, federally insured thrift deposits outside of Texas grew 56 percent nationwide between 1982 and 1987. In Texas, deposit growth was 148 percent.

Failure to Deal Effectively With FSLIC Problems May Make It Harder to Ensure the Soundness of FDIC

How FSLIC's problems are handled may have consequences for FDIC. Although FDIC's problems are not as severe as FSLIC's, it too faces potentially large demands. We noted in chapter 1 that, as a result of recent losses, FDIC's reserves in relation to deposits are at their lowest point in years and that more losses can be expected. FDIC officials have indicated that FDIC's reserves are likely to decline in 1988, after which they expect the condition of the fund to improve.

Our analysis of the outlook for FDIC suggests, however, that FDIC may have a difficult time maintaining adequate reserves over the next several years. Even if FDIC's view that its reserves will start to increase in 1989 proves correct, insurance losses in the years 1990 through 1992 would have to be extremely small in relation to experience over the past 5 years if FDIC is to bring its reserves up to the existing legislative standard of 1.1 percent of insured deposits by 1992. (See app. II.)

The way the FSLIC insolvency is handled may set a dangerous precedent for how the problems of insolvent and undercapitalized FDIC-insured banks are handled, thus weakening the regulatory process. An overriding policy choice that must be faced is whether to let bad regulatory practices in areas such as lack of enforcement of capital standards, closure policy, and the like become the standard for depository institutions, or whether to attempt to set a high standard for risk management that will eliminate the perpetuation of mistakes made in the past.

In this regard, we are particularly concerned about the growth in the number of weakly capitalized commercial banks—banks with less than 3 percent capital on a GAAP basis. (See table 3.1.) Many of these weakly capitalized banking institutions are operating under an explicit program of capital forbearance (i.e., relaxation of enforcement of capital standards) in the hope that their plans for restoring capital to adequate levels will prove successful.[1,2]

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[1] In its January 10, 1989 comments on our draft report, FDIC said that there are currently 129 banks in its capital forbearance program and 31 banks that FDIC, as required by law, is allowing to defer losses on agricultural loans. FDIC noted that as of November 1988, 18 percent of the state banks admitted to its program have been closed or had their forbearance eliminated, while 10 percent improved or were merged with another institution.

[2] Under the risk-based capital guidelines that are being developed for banks, equity capital will have to be 4 percent of weighted assets, with weights based on credit risks of different asset categories. Total capital will have to be 8 percent. Banks are to achieve this goal by 1992.

Table 3.1: Insolvent and Weak Commercial Banks: 1980 Through June 30, 1988

Dollars in millions

Year[a]	Number of insolvent banks[b]	Assets in insolvent banks	Number of weak banks[c]	Assets in weak banks
1980	1	$17	14	$1,669
1981	2	37	21	4,054
1982	5	179	43	4,235
1983	14	3,249	74	5,445
1984	8	250	68	7,098
1985	25	1,379	110	8,432
1986	58	2,588	203	19,235
1987	66	8,772	250	114,728
1988 (June 30)[d]	80	25,129	231	92,864

Source: FDIC's consolidated reports of condition and income.

[a] Information is as of December 31 for each year except 1988.

[b] An insolvent bank has negative GAAP capital.

[c] A weak bank has a GAAP capital to asset ratio between 0 and 3 percent.

[d] In its comment letter, FDIC said there were 90 insolvent banks as of mid-year 1988. FDIC's figure is higher than ours because FDIC has been able to update its data base for banks that completed their June 30 reports after FDIC provided us the computerized data. FDIC also noted in its comment letter that 70 of the 90 institutions were either closed or merged out of existence in the second half of 1988, gained solvency during the third quarter, or have assistance proposals currently pending.

Conclusion

The message of this chapter is a simple one. It will be less expensive in the long run and better for the financial system as a whole if FSLIC can be restored to financial health as soon as possible.

To restore FSLIC to a sound financial footing, which includes ensuring to the greatest extent possible that the mistakes of the past are not repeated, three sets of outcomes must be realized:

- The manner in which insolvent thrift institutions are resolved must be changed.
- Risks that are underwritten by the insurance funds must be better managed than they have been in the past.
- The money to fully resolve insolvent institutions must be provided.

The manner in which we believe these outcomes can best be achieved is discussed in the next three chapters. The relationship of a merger of the funds to the efficacy of actions needed to achieve the outcomes is discussed in chapter 7.

Agency Comments and Our Evaluation

FDIC and NCUA provided comments relevant to this chapter. Both agreed that it was important to resolve insolvencies as soon as possible. FDIC also told us that there were 90 insolvent banks as of mid-year 1988 (versus our preliminary figure of 48 shown in the draft report), and FDIC also discussed actions taken on these institutions during the second half of 1988. FDIC said 70 of the 90 insolvent banks were either liquidated or merged out of existence, returned to solvency, or have assistance plans pending. FDIC noted that it anticipates that all of the remaining insolvent institutions will be closed, recapitalized, or otherwise resolved within the ensuing months.

In response to FDIC's comments we reviewed and revised our June 30, 1988, statistics on insolvent and weak banks in table 3.1 (and table II.3) and included an explanation of FDIC actions in a note to the tables.[7] The revision results in a somewhat higher number of both insolvent and weak banks maintaining the validity of our concern that nearly 4 percent of banking industry assets were in insolvent or weak banks as of June 30, 1988. (See app. II, table II.3 for this computation.)

In response to our concern about the number of weak banks, FDIC also provided data on its forbearance program explaining how it requires institutions to be both solvent and viable to qualify for the program and how institutions are removed from the program if they fail to adhere to their recapitalization plan. Because we have not recently evaluated FDIC's forbearance program, we have no basis to question FDIC's explanation of program operations. We included FDIC's statistics on forbearance activity in a footnote to our discussion of weak banks on page 49.

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[7] As explained in the notes to table 3.1, figures in our data base still differ slightly from FDIC's because of information missing at the time FDIC provided us with the computerized data, but which was subsequently available to FDIC.

Chapter 4

Procedures for Resolving Insolvent Thrifts as Quickly as Possible

In the last chapter, we emphasized the importance of dealing with insolvent thrifts as quickly as possible. The costs and damage from moving slowly are too high. While FSLIC has dealt with a large number of insolvent institutions recently, we are concerned that FSLIC is trying to resolve cases through assisted merger agreements even when this is not the most appropriate solution. We also believe FSLIC needs to implement an alternative case resolution approach that allows it to quickly take control of insolvent institutions even before final resolutions are decided upon.

Concerns Over FSLIC's Approach

The FSLIC strategy is to use assisted mergers as a means for resolving as many problem thrift cases as possible with the limited funds available. FSLIC's July 1988 cash flow projection anticipated that about three-fourths of its case resolution expenditures through fiscal year 1998 will be incurred in merger actions. In 1988, assisted mergers accounted for about 90 percent of the costs incurred in acting on problem cases.[1]

FSLIC analyses show that mergers are often less costly than liquidations, and FHLBB officials believe mergers are not as disruptive to the market because creditors and depositors are less affected by a merger than by a liquidation. We agree that well-designed mergers can be an important part of a strategy for resolving insolvent thrifts. However, FSLIC's estimates of its merger costs for many individual institutions are now approaching FSLIC's estimated liquidation costs for those same institutions. Also, lost tax revenues, uncertainties regarding the ultimate cost of mergers to the fund, and technical features of FSLIC's cost analyses may distort the calculations by understating the cost of mergers to the government.

The convergence of FSLIC's estimated merger and liquidation costs is shown in table 4.1. For those institutions that were merged, this table shows (1) the present value loss booked by FSLIC as a percent of total assets of the insolvent institutions that were merged and (2) FSLIC's estimated present value cost of liquidation as a percent of total assets of the same insolvent institutions.[2]

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[1] Costs are calculated on a present value basis. Merger costs include stablization cases which are similar to assisted mergers but require further case resolution action.

[2] It should be noted that this table only deals with FSLIC merger actions (including 18 stabilization cases) and does not compare the estimated average cost of all FSLIC liquidations with the estimated average cost of all mergers.

Table 4.1: FSLIC Merger Actions: Average Estimated Merger Cost Booked by FSLIC and FSLIC's Average Estimated Cost of Liquidating Those Merged Thrifts (1985-1988)

	(Cost expressed as percent of the assets in cases acted on during the year)[a]	
Year	Merger cost	Estimated Liquidated Cost
1985	7.0%	19.4%
1986	5.5	9.5
1987	27.6	33.1
1988 (through September 30)[c]	59.0	66.4

[a] As noted in the text, in our opinion FSLIC's calculations on balance tend to understate the potential costs of merger to the federal government.

[b] Figures are a weighted average computed by summing the total present dollar value of estimated liquidation costs (or estimated merger costs) for thrifts that were merged during the time period and dividing by total assets as shown on the thrifts' most recent financial statements prior to merger.

[c] Includes stabilization actions. Excluding stabilizations, the percentages are 45.5% estimated merger costs and 54.9% for estimated liquidation cost.

Source: Federal Home Loan Bank Board.

Figure 4.1, based on the data in table 4.1, shows that estimated merger costs are approaching estimated liquidation costs. In 1988, for mergers conducted through September 30, FSLIC calculated that its merger agreements would cost on average 89 percent as much as liquidating those institutions.[1]

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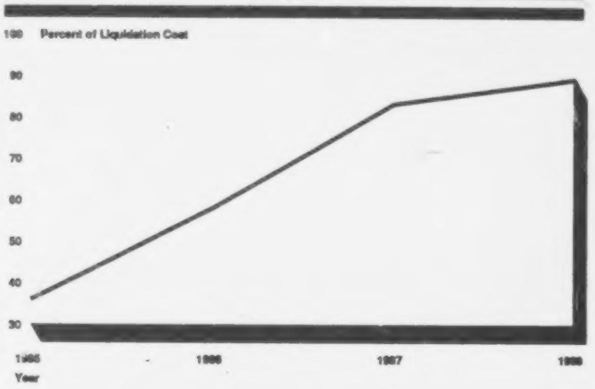
[1] Excluding stabilization actions, merger agreements were estimated to cost 83 percent as much as liquidating those institutions.

Figure 4.1: FSLIC Merger Actions: Estimated Merger Cost Booked by FSLIC as a Percentage of FSLIC's Estimated Cost for Liquidating These Same Institutions



Note: This chart is based on percentages contained in table 4.1.

When FSLIC is deciding how to resolve an insolvent thrift, it estimates on a present value basis how much it would cost to liquidate the thrift and compares it with the estimated cost of merging it, given the bid(s) on hand. There is a considerable element of uncertainty in both calculations. For example, when the decision is made, the actual market values of the thrift's assets are not known. There are some differences in the calculation of liquidation versus merger costs that, in our opinion, on balance tend to understate the potential costs of merger to the federal government.

One of these considerations is tax losses. Profitable institutions acquire an unprofitable thrift in part because they can use certain losses in the acquired institutions to reduce their federal tax liability. In addition, FSLIC assistance is tax free for deals arranged by December 31, 1988. The overall tax benefits to the acquirer are reduced for resolution transactions occurring after December 31, 1988. FSLIC generally reduces the amount of FSLIC assistance to take account of some or all of the acquirer's tax benefits. From FSLIC's standpoint, it makes sense not to count the acquirer's tax benefits as a cost to FSLIC of the merger when comparing that cost with the cost of a liquidation. However, from the point of view of the U.S. Treasury, all tax benefits including those used to reduce FSLIC's cost of merger calculations, represent lost revenue and therefore a real cost to the government.

Uncertainties associated with the merger agreements may also increase their cost as time goes on. For example, because of the capital loss and yield indemnification guarantees FSLIC has provided in recent mergers, it remains exposed to capital and operating losses on nonperforming assets in the merged institutions. Clearly, in a liquidation, FSLIC also is exposed to fluctuations in the value of nonperforming loans or their underlying collateral, but in that situation FSLIC maintains control of the liquidation process to maximize its return. In the case of assisted mergers in which nonperforming assets are transferred to the acquiring institution, FSLIC does not maintain the same degree of control over the liquidation of such assets. We question whether the yield maintenance and capital loss indemnification agreements offer sufficient assurance that the acquiring institution will behave in the best interest of FSLIC.

In addition, some institutions being created by FSLIC-assisted mergers are the result of merging two or more insolvent thrifts to create a thrift that is thinly capitalized. In other cases, ownership capital contributed by outside private investors has been below the capital adequacy standard for the industry. FSLIC estimates the viability of a potential acquisition over the next 5 to 10 years on the basis of the business plan submitted and information in the bid proposal. The viability assessment takes into account FSLIC assistance that would be provided. FSLIC does not expect the acquiring institution to be profitable initially. FSLIC expects to see evidence that a movement toward profitability (i.e., a reduction in negative net income) can be anticipated over the ensuing 5- to 10-year period.

We believe it is reasonable to expect that some of the resulting institutions may require further assistance—or liquidation—in the future, unless they become truly profitable. Because of their larger size, the new thrifts may be even harder to deal with if failure does occur. This potential for additional assistance cost, which does not exist when liquidation is used, is not taken into account when comparing the costs of liquidation and merger.

Finally, technical factors also may make FSLIC's deals less advantageous to the government.

- In estimating the present value cost of mergers and liquidations, FSLIC uses the FICO borrowing rate. If an adequate financing plan were available, it would be more appropriate to use the lower Treasury borrowing rate. This adjustment would tend to increase the relative cost of mergers.
- The costs of FSLIC's merger agreements have been compared with the most costly liquidation alternative—outright liquidation of all institutions included in the deals. With adequate funding, other alternatives for resolving the cases at lower cost to the government could be considered.

The first transaction under FSLIC's Southwest Plan, involving Coastal Savings, illustrates how small the difference between estimated merger and liquidation costs has been recently. The acquisition of four troubled thrifts by Coastal raised its assets from about $70 million to $540 million. FSLIC estimated this acquisition would cost the fund $146 million. FSLIC estimated that this cost represented a savings of about 6 percent over the cost of a liquidation. However, FSLIC continues to bear the risk of less favorable outcomes if Coastal is unable to profitably manage its new assets and become a viable institution, independent of FSLIC assistance.

In addition to cost consideration, we have concerns about many of the assisted merger agreements that FSLIC has used to act on cases in 1988.

- The institutions resulting from the assisted mergers are heavily subsidized by FSLIC, and they are competing with healthy nonassisted depository institutions at a cost advantage.
- FSLIC faces a huge task in effectively administering these complex agreements.

We have begun work to assess in detail the merger and other resolutions of specific insolvent thrifts that have occurred. This work will examine the risks to FSLIC and any controls it plans to utilize.

An Alternate Approach Is Needed

With the cost of mergers now approaching that of liquidation for many institutions, the desirability has increased for finding other ways to control costs. It would be unfortunate if the rate at which FSLIC is able to resolve cases continues to be largely dependent on FSLIC's ability to execute merger arrangements such as those described above.

A key to expeditiously resolving cases, while at the same time minimizing FSLIC's costs, is first to be sure there is enough money in the insurance fund to take the most appropriate action. With the money available, a process could then be applied in which FSLIC moves as soon as possible to resolve insolvent institutions. We think that this can best be done by having the government take control of all insolvent institutions. These institutions can then be adequately valued and liquidated or merged while additional economic cost is minimized. In accordance with the cost estimates discussed in chapter 2, we think it likely that case resolution decisions could be completed by the end of 1991.

Under this arrangement, the government would place the thrifts into receivership whenever necessary, remove directors, replace management, and sharply curtail the institutions' activities. The institutions would continue to provide certain services, but strictly as a convenience to their existing customers until such time as a decision is made to rehabilitate, merge, or liquidate them. Managers assigned to such institutions would concentrate on account servicing and evaluation of, and recovery on, assets. The institutions would shrink in size and be able to perform only specified functions to prevent risk taking, with all investment being restricted to government securities and other high-quality assets.

One of the principal problems with FSLIC's current approach to resolution is that, at the time mergers are accomplished, complete information on the financial condition of the institution is often not available. For this reason, FSLIC issues guarantees on broad asset categories to cover unknown losses. One of the advantages of FSLIC taking control is that it would allow time to make a better determination of what the losses in institutions might be, while not allowing management practices that permitted the institutions' insolvency to continue. Under this arrangement, the reliability of the decisions to rehabilitate, merge, or liquidate institutions, and the resulting cost estimates, would be more certain.

The deposit insurance system already provides several mechanisms for the deposit insurance agencies to use in taking control of failed institutions. One is in the thrift industry. For several years, FHLBB has placed selected thrifts into what it calls the Management Consignment Program (MCP). These thrifts have been placed into receivership or conservatorship and the boards of directors and management removed. It expects the new officials of the MCP to draw up business plans to keep the institutions from deteriorating further and, if possible, to rehabilitate them or make them more attractive to prospective purchasers. As of July 31, 1988, a total of 83 institutions at one time or other had been assigned to this program, and 56 were in the program at that date. Of the 27 MCP institutions that were no longer in the program, 17 were liquidated and 10 were merged with or acquired by another institution.

FDIC provides three methods for insurance fund control of failing or failed institutions. The least stringent of these is open bank assistance. In this approach, exemplified by the 1984 rescue of the Continental Illinois National Bank and Trust Company, FDIC exacts changes in the composition of the board of directors and in top management in return for providing assistance. The Competitive Equality Banking Act of 1987 authorized FDIC to establish another mechanism, termed bridge banks, under which an institution placed in receivership is given a temporary charter. In these instances, FDIC replaces directors and top management of the bank until the case is resolved. FDIC recently used a bridge bank in a Texas case. Finally, FDIC can also establish what are called Deposit Insurance National Banks (DINB). DINBs are used to keep failed banks open on a very restricted basis for up to 2 years until the institutions can be recapitalized and sold or liquidated on an orderly basis.

Of the various mechanisms, the DINB mechanism seems most appropriate for dealing with many of the insolvent thrifts, although some of the DINB restrictions, such as the 2-year limit, may need to be modified. The other approaches are more open ended and allow what are essentially nationalized institutions to seek new deposits, make new loans, and otherwise compete in providing the full range of services authorized under their charters. Because the purpose of taking control of the insolvent thrifts is to reduce losses and provide for their optimum resolution, the approach selected should include tight restrictions on investments and on the interest rates that can be paid on deposits.

Under an approach based on the DINB model, operating losses would continue but could be reduced. One reason the DINB approach could reduce operating losses is that premium interest rates to attract funds would be eliminated, as would expenses for advertising and marketing. Furthermore, some types of management expenses could be cut because there would be no need to attract or retain personnel skilled in making new loans or developing complex investment strategies. FSLIC would, however, have to be prepared to advance money for liquidity (or to arrange for such advances) if depositors withdraw funds quickly.

An alternative approach would be to place all insolvent institutions into receivership in a single federally controlled holding arrangement that would be supervised by a specially appointed board.[4] It would be clear that all institutions acted upon in this way had failed. Excessive risk taking and the accompanying losses would be eliminated. Furthermore, these institutions would no longer be competing with well capitalized thrifts and banking institutions in making loans or in offering premium interest rates on deposits.

Administrative Resources

Seeking to resolve FSLIC's problem cases by first taking control of a large number of institutions requires two principal tasks—deciding the true condition of each problem institution and overseeing either the liquidation or acquisition of the institutions' assets. Accomplishing these tasks would increase demands on FSLIC's and FHLBB's resources. Although FHLBB has already initiated reorganization in some areas in response to increased demands, accomplishing these tasks expeditiously will no doubt require additional staff.[5] In this regard, administering the merger deals that have already been completed will place heavy demands on FSLIC staff.

An initial determination of which institutions should be placed into receivership and which should be handled by other means could be accomplished through mobilization of the resources that exist within the federal regulatory structure. To help make the necessary determinations, FSLIC could arrange with FDIC, the Federal Reserve System, the Comptroller of the Currency, and state regulators to perform examination functions on a relatively short-term basis. A recent precedent for accomplishing this may be found in the cooperative response of the bank regulatory agencies in dealing with the 1985 crisis involving state-chartered thrifts in Ohio. In that instance, determinations needed to be made quickly about which uninsured state-chartered thrifts would qualify for FSLIC insurance coverage.

The management of assets to be liquidated would probably require a dramatic increase in FSLIC personnel and other changes to its asset management structure. FSLIC's current structure for dealing with assets places little reliance on federal employees to actually handle the assets.

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[4] A proposal along these lines was contained in The FSLIC Crisis: Principles and Issues—a Call to Action, prepared by the American Bankers Association (Sept. 20, 1988).

[5] For a description of the restructuring that has taken place in the Bank Board during 1988, see pages 1-16 of the Statement of M. Danny Wall, Chairman of the Federal Home Loan Bank Board, before the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, July 7, 1988.

As presently constituted, FSLIC is not in a position to immediately manage a dramatic increase in assets. When presented with the need to handle additional assets a few years ago, FHLBB created the Federal Asset Disposition Association (FADA); however, we recently found that its creation was not proper.[6]

If a major effort to quickly take control of insolvent thrifts were launched, FSLIC would immediately need additional asset management resources. If it is unable to fully resolve issues that have impeded its development of adequate resources using FSLIC employees, receivership personnel, and private-sector firms, FSLIC could consider use of FDIC's asset management structure and personnel.[7] FDIC is a much larger agency than FSLIC. FDIC has developed a flexible, decentralized structure for the in-house management of assets from failed institutions using temporary federal employees. While FDIC has a heavy asset management workload, it anticipates that its workload may decline in 1990. Even if the workload does not decline, FDIC's more flexible structure would permit it to add temporary staff more easily than would FSLIC's. FSLIC would have to retain enough control over the asset management process to meet its legal and fiduciary responsibilities.

Although FSLIC might need to use FDIC's structure and personnel only until it can develop its own system and resources, combining assets acquired from failed banks and thrifts for management and liquidation might provide some opportunity for the packaging of assets for sale and the pacing of sales that would improve the return to both FDIC and FSLIC. The deposit insurance funds could also take advantage of any economies of scale.[8]

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[6] Letter to Sen. David Pryor, Chairman of the Subcommittee on Federal Services, Post Office, and Civil Service, Senate Committee on Governmental Affairs, (Sept. 6, 1988).

[7] A recent precedent for contracting with FDIC for assistance exists within the Farm Credit System. In 1988, the Farm Credit Administration contracted with FDIC for assistance with respect to the closing of the Federal Land Bank of Jackson, Mississippi.

[8] Our report entitled Failed Banks: FDIC's Asset Liquidation Operations (GAO/GGD-88-132, Sept. 28, 1988), describes the FDIC policies and process.

Taking Control of Insolvent Institutions Does Not Mean Assets Will Be Dumped

One of the arguments for slowing down liquidation of insolvent thrifts or, alternatively, for allowing them to remain open, is that closing these institutions more rapidly means dumping substandard assets in already depressed markets. Such a massive sell-off, it is argued, would gain FSLIC little and would create more hardship by further lowering asset values in areas of the country where markets are already depressed.

Moving quickly to take control of problem institutions does not necessarily mean that assets would be sold too quickly. Under receiverships, nonperforming loans, distressed real estate, and other assets owned by liquidated thrifts are not sold immediately. The rate of asset liquidation within a receivership is calculated to maximize the discounted net return to the receivership and therefore liquidation officials have an interest in timing asset sales so as not to unduly depress prices. In the past, there has been a significant lag before disposal of the assets. In computing the estimated costs of liquidation and merger for a 5-year receivership, for example, FSLIC assumes a reduction of 30 percent per year in years 2 through 4 and 10 percent in year 5 for all problem assets. Furthermore, economic theory suggests that asset prices in depressed markets are likely to already incorporate expectations about the existence of a large overhang of assets in insolvent institutions that may come on the market. Therefore, FSLIC takeovers of insolvent institutions would not necessarily depress markets.

Conclusions

FSLIC's plan to rely almost exclusively on assisted mergers to resolve insolvent thrifts ultimately ties the pace of case resolution to the availability of suitable acquirers. Of more fundamental importance, the unknown value of assets causes uncertainty over what FSLIC's costs will ultimately be on the recent assisted mergers. Cost calculations also do not include the possibility that the institutions created by the mergers will require additional assistance.

Alternative approaches are needed that allow FSLIC to take control of insolvent institutions as quickly as possible so it can reduce potential costs to the insurance fund by minimizing future losses and by eliminating the tendency for insolvent thrifts to pay higher interest rates than do solvent thrifts. FSLIC would also gain time to evaluate the true condition of the thrifts, make realistic estimates of the cost of liquidation or merger, and either negotiate with an acquirer or arrange for orderly liquidation. One approach, the rapid deployment of a combined regulatory task force, which occurred during the Ohio savings and loan crisis, could help identify asset quality and other problems in insolvent institutions.

FSLIC's current asset management structure and resources, however, may not presently be equipped to deal immediately with the large amount of assets that could be acquired. One solution to this problem would be entering into an arrangement with FDIC for needed assistance.

Recommendations

We recommend the following:

- The government should promptly take control of insolvent thrifts, placing these institutions in a receivership arrangement when necessary until a decision to rehabilitate, merge, or liquidate them can be made on the basis of a careful study of their asset portfolios and the net cost of each approach. In the interim, supervisory and insurance officials should limit the operations of these institutions to investing in high-grade securities, managing bad assets on the books, and accepting insured deposits from existing customers at market rates.
- FHLBB should form a task force of regulators and insurance officials to assess the quality of assets in insolvent thrifts for purposes of deciding which thrifts should be rehabilitated, merged, or liquidated.
- FSLIC should arrange with FDIC or other regulatory agencies for any required assistance.

Agency Comments and Our Evaluation

FHLBB and the Federal Reserve provided comments relevant to this chapter.

FHLBB said that all of its actions attempt to minimize insurance fund costs. It stated that with more cash it could perform additional liquidations, but that assisted mergers are the preferred course of action because they take advantage of the values represented by core deposits and mortgage origination business. FHLBB also said that its current case resolution process is consistent with our recommendations, citing particularly regulations restricting growth and several MCP and stabilization actions.

The FHLBB comments do not address our main point. We recognize that FHLBB has now adopted regulations controlling growth and other activities of insolvent institutions and that merger arrangements of some type often prove to be the best way to resolve cases. However, our main point is that the whole approach that the Bank Board has taken to resolving cases has been fundamentally flawed.

In recent years the federal government has been involved in several financial rescues of smaller magnitude than the FSLIC rescue. In 1984 we issued a report, based on the government's experience with Chrysler, New York City, and several other situations, containing guidelines about how such efforts should be structured.[9] The guidelines underscore the importance of developing an adequate plan for financing, implementing, and overseeing these types of situations.

The Bank Board's actions have not been consistent with these guidelines. The Bank Board began to close institutions and obligate the government to pay large amounts of money over the next 10 years without first implementing reforms or assuring that adequate sources of financing were available. As late as the summer and early fall of 1988 FHLBB presented information to Congress suggesting that it had the resources it needed. Furthermore, although its regulations concerning the activities of insolvent and weakly capitalized institutions have gotten much better, it has not had the administrative capability to fully take control of all insolvent institutions or to fully assess alternative ways to resolving problem cases.

In response to FHLBB's comments, we expanded our explanation of concerns about FSLIC case resolution deals. We recognize that FHLBB's lack of money limited its options.

FHLBB said that the extension by the government of full faith and credit to FSLIC notes and guarantees would reduce FSLIC's resolution costs. In our view the government's full faith and credit is already pledged. Should FSLIC be unable to pay on the notes and guarantees the government will be obligated to do so, although presently there is no source of funding designated for such payments by the government. To the extent Congress wishes to alleviate apparent uncertainty in the marketplace concerning the full faith and credit issue, it could enact legislation specifically pledging the government's faith and credit to FSLIC's notes and guarantees. However, we believe any consideration of the status of FSLIC notes and guarantees should also consider appropriate controls over the use of such obligations.

In its comments, the Federal Reserve said it recognizes the magnitude and complexity of the problems facing the thrift industry and is certainly willing to play a constructive and appropriate role in addressing the situation. After corroborating our description of its role in Ohio and

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[9] Guidelines for Rescuing Large Failing Firms and Minicipalities (GAO/GGD-84-34, March 29, 1984).

Maryland thrift crises, the Federal Reserve said it remains ready to provide an appropriate measure of assistance to other federal and state regulators, consistent with its available resources and responsibilities for promoting safe and sound conditions within the banking and financial system.

Chapter 5

Risk Management and Deposit Insurance Reform

To keep FSLIC's current situation from being repeated in either FSLIC or FDIC, better risk management in the deposit insurance system is needed.[1] This requires bringing funding sources and exposure to risk into better balance so that the insurance funds will have enough money to pay for the losses they expect to incur.

This chapter discusses immediate changes to risk management policies that are needed to protect the integrity of the deposit insurance system. We also discuss more far-reaching reforms to the deposit insurance system that need not be implemented right away but which could, in the future, reduce the likelihood of unfunded insurance losses.

Basis for Concern

Until the present decade, both banks and thrifts were protected from competition by regulations limiting entry into the industry, the interest rates they could pay, and the geographic areas in which they could operate. However, during the 1980s it became clear that changes in the economy, in the technology associated with financial services, and in the number and types of services offered by financial institutions of all types rendered many of the regulations limiting competition ineffective or even counterproductive in protecting the safety and soundness of depository institutions. Many regulations have been relaxed and it is unrealistic to return to the segmented, highly regulated markets of the past. Looking to the future, therefore, we think risk management decisions must be based on the assumption that risks facing the deposit insurance system are greater and more unpredictable than in previous decades when the deposit insurance system experienced few losses.

Without better management over the exposure of the deposit insurance system to today's risks, the losses that the funds may have to underwrite are potentially enormous. The loss potential is amply demonstrated by the number of insolvent institutions in the thrift industry, the heavy losses FSLIC has been experiencing, and by the fact that, in 1988 (through September 30), FSLIC experienced loss ratios in excess of 100 percent of the assets in at least eight of the institutions it acted on.

There are three interrelated elements of successful risk management:

- providing adequate funding sources to pay the bills because without funding, the credibility of other means of controlling losses to which the insurer is exposed becomes questionable;

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[1] Risk is defined as the possibility of financial loss.

- ensuring the adequacy of insured institutions' capital that serves as a buffer to protect the deposit insurance funds from losses; and
- better managing exposure to losses through such things as more vigilant oversight and supervision and not permitting insolvent institutions to continue operating.

In response to continuing losses in both FSLIC and FDIC, federal regulatory officials have taken steps that use each of these approaches in addressing risk management issues.

- To raise funds, FHLBB has implemented a special premium and the $10.8 billion recapitalization.
- To provide a greater buffer for the insurance fund, regulators in both industries have also raised the amount of capital that is considered adequate for regulatory purposes.[2]
- To help control risks, FHLBB issued regulations to curtail both the growth of poorly capitalized thrifts and activities such as direct investments that are perceived to be particularly risky.[3]
- In addition, supervisory staff of both the banking and thrift regulators have been increased and efforts have been made to improve the quantity and quality of supervisory oversight, including examinations.

These actions represent steps in the right direction. But much more needs to be done to ensure that the types of experiences associated with FSLIC's insolvency do not occur again.

Approaches to Risk Management

There are two general approaches to achieving better control over risks borne by the deposit insurance system. One approach is to build on the current system, making improvements that will increase funding and reduce exposure to the risks that are insured under current arrangements in both FSLIC and FDIC. The other approach is more far-reaching and involves changing the kinds of risks that deposit insurance underwrites.

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[2] Under CEBA, FHLBB must prescribe uniform accounting standards and capital requirements consistent with those for commercial banks.

[3] In 1983 and 1984, the thrift industry experienced significant deposit growth. This growth was also experienced by under-capitalized and insolvent institutions. For example, in 1983, deposits in GAAP-insolvent thrifts grew at a rate of 14.5 percent, while the industry growth rate was 21 percent.

Building on the Existing System

Building on the existing system of deposit insurance requires that changes be made to funding, capital requirements, and loss control policies to achieve a more satisfactory match between funding levels and risks underwritten by the funds. We believe that, at a minimum, six changes need to be made to provide reasonable assurance that FSLIC's insolvency is not repeated in the future.

These changes are

- providing more flexibility in funding,
- strengthening regulation and enforcement of capital adequacy,
- providing greater independence and ability to deposit insurance officials to protect the integrity of the deposit insurance funds,
- improving supervisory capability and related risk control infrastructure,
- clarifying the responsibilities of holding companies for maintaining adequate capital in their insured depository institutions, and
- achieving consistency in the regulation of banks and thrifts where differences can represent a material threat to the deposit insurance funds.

More Flexibility in Funding

Putting to one side the question of paying the bills on FSLIC's current problem cases, deposit insurance funding arrangements for both FDIC and FSLIC need to change. The law does not permit FDIC to raise its premiums above one-twelfth of 1 percent of domestic deposits, nor FSLIC to increase its premiums by more than the special premium now in effect. This inability to relate premiums to loss experience is an obvious limitation.

To be effective in discouraging risk taking by insured institutions, the deposit insurance funds need to have sufficient reserves to take prompt action to resolve the case of any institution that fails either to maintain adequate capital or to refrain from engaging in unsafe and unsound practices. If the cost of deposit insurance has risen, directors of the deposit insurance funds should be able to increase premiums, just as occurs in private sector insurance, so that adequate levels of reserves can be maintained. Additional borrowing authority should also be provided to both FDIC and FSLIC to minimize the chance that the ability of the system to operate would be compromised by temporary liquidity problems.

Strengthened Regulation and Enforcement of Capital Adequacy

To improve the buffer provided by capital in insured institutions, federal regulators of commercial banks are in the process of developing capital adequacy regulations that would reflect differences in the risk characteristics of assets held by individual institutions. These regulations, developed in cooperation with regulatory officials in other nations, for the first time bring a direct link between risk and capital into the capital structure of commercial banks.[4]

FHLBB has also proposed capital requirements that take into account differences in the activities of insured thrifts. The variations in the capital requirements that are or are likely to be applicable in both FDIC- and FSLIC-insured institutions fall far short of true pricing of risk. However, a link between risk and capital requirements and encouragement of subordinated debt to help meet higher capital needs may reduce the incentive for institutions to take excessive risks.[5]

Capital requirements have to be enforced if they are to be effective in influencing the risk-taking behavior of the owners and managers of depository institutions. Therefore, another change that needs to be made to the existing system is to make it clear that institutions will be closed whenever their capital, as defined in capital adequacy regulations, approaches zero. While this represents an improvement in the management of insurance fund risk, it will by no means eliminate insurance fund losses.

FDIC is experiencing average insurance losses of about 30 percent of assets on cases of banks under $500 million assets it had to resolve by liquidation or assisted merger. The basic reason for this seems to be that as reported levels of capital approach zero, real capital is well below that amount because managers of troubled firms are likely to have done everything possible to avoid or delay recognizing losses. The success of a closure policy in reducing insurance fund exposure to risk depends on the willingness of federal officials to monitor the condition of problem institutions closely and to close institutions promptly when their capital is gone.

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[4] Under existing arrangements, on a judgmental basis, regulators impose additional capital requirements on institutions deemed to be too risky. Ability to do this would continue under the new regulations.

[5] Subordinated debt is debt whose claim on the assets of the institution if it should fail is of lower priority than that of the deposit insurance funds and other general creditors. See appendix IV for additional discussion of the limitations of risk-based capital.

We are particularly concerned about the FHLBB's willingness or ability to carry out a policy of promptly closing institutions. Most of FHLBB's supervisory activities are carried out by employees of the Federal Home Loan banks, which are owned by the industry. Because of FHLBB's responsibility for promoting the industry's role in housing finance, we also are concerned about whether closure policies for thrifts comparable to those provided for FDIC-insured banks can be achieved by FHLBB.

Another important part of enforcing capital standards is applying sanctions to institutions that are not insolvent but fail to maintain adequate capital. In 1987, the assets of 685 solvent but undercapitalized institutions (GAAP capital between 0 and 3 percent of assets) in the commercial banking and thrift industry totaled about $370 billion. (See table 5.1.) Given that financial statements are not prepared on a market value basis, this number of poorly capitalized institutions is cause for concern. If the condition of a large proportion of these institutions should deteriorate substantially, insurance losses for FDIC as well as FSLIC will increase.

As noted above, FHLBB, FDIC, and other bank regulatory officials recognize the dangers posed by undercapitalized institutions and they have taken steps to improve the monitoring and supervision of such institutions. To protect the deposit insurance funds, we believe these efforts need to be intensified and backed up with regulations and supervision that curb or forbid growth, nonconservative risk-taking strategies, and payment of above-market rates on insured deposits by undercapitalized institutions. Dividend payments and executive compensation are other areas in which more stringent controls on the practices followed by undercapitalized institutions may be needed.[a]

Table 5.1: Solvent but Undercapitalized Institutions in the Commercial Banking and Thrift Industries, December 31, 1987

Dollars in billions

Industry	Number of institutions	Assets
Commercial banking	250	$115
Thrifts	435	255
Total	685	$370

Note: Institutions with net worth on a GAAP basis of 0 to 3 percent

Source: Tables 2.1 and 3.1

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[a] In curbing the growth of these weak institutions, FSLIC, the Federal Home Loan Bank System, FDIC, or the Federal Reserve System might have to be prepared to lend funds to institutions to replace funds withdrawn by market participants. This would be necessary if a sufficiently large number of depositors were no longer willing to place deposits in poorly capitalized institutions whose ability to offer above-market rates to attract deposits has been curtailed.

Greater Ability for Deposit Insurance Officials to Protect the Integrity of the Deposit Insurance Funds

Under current arrangements for chartering, regulating, supervising, and insuring depository institutions, responsibility for trying to keep both FSLIC and FDIC from experiencing unfunded losses in effect is shared among a number of federal and state officials. However, to help ensure that FSLIC's situation is not repeated, we believe deposit insurance officials need to have both a clear mandate and sufficient powers so that they can be held more accountable for protecting the integrity of the insurance funds they administer. The biggest problem now is FSLIC's lack of independence.

Because of our concerns over the ability of FHLBB to effectively regulate, oversee, and supervise the thrift industry while at the same time promoting the industry's interests, we have doubts that the independence of FSLIC can be appreciably enhanced as long as it remains an integral part of the FHLBB, subject to its direction. For this reason, we believe that FSLIC should be disengaged from FHLBB and made independent similar to the organizational model that exists for FDIC and the banking industry regulators.

One way to enable an independent FSLIC to better protect the insurance funds is to enable it to take steps to ensure that the kinds of risks being underwritten are reasonably consistent across federally and state-chartered institutions. FSLIC currently insures some state-chartered institutions that have greater freedom to engage in certain risky activities than do federally chartered institutions. As a result, these state-chartered institutions can often impose greater risks on FSLIC than can federally chartered thrifts.

Many observers have pointed out that state-chartered institutions have served as a major source of innovation within the banking industry. However, the disparity between the powers of federally and state-chartered institutions that exposes the insurance funds to losses is hard to justify in a flat-rate deposit insurance system. If this disparity cannot be eliminated, and if all institutions are to be charged the same premiums, then an independent FSLIC needs to be able to refuse to insure new state-chartered institutions whose powers are likely to generate risks substantially greater than those associated with federally chartered institutions.

Similarly, an independent FSLIC needs to be able to cancel insurance coverage expeditiously or to take other steps, such as increasing premiums, issuing cease and desist orders, or requiring increased levels of capital for any class of institutions that exercises powers that can be demonstrated to involve a material level of risk not found in federally chartered institutions. Similar powers are needed in situations involving individual undercapitalized federally or state-chartered institutions or other situations that threaten the fund.

With sufficient powers to protect the fund for good cause shown—and with adequate resources to accomplish this—an independent FSLIC would be in a much better position than FSLIC is now in to impose discipline in the thrift industry and to assure implementation and enforcement of actions that have a material effect on deposit insurance finances. Such an arrangement involves the possibility of creating some friction between deposit insurance and other federal or state chartering and supervisory officials. However, in our view, this is a lesser evil than leaving an independent FSLIC in a situation in which it is unable to take the actions needed to protect the integrity of the fund.

In carrying out its duties, an independent FSLIC will need to develop an adequate supervisory capability for both federally and state-chartered institutions. Because it will take time to acquire and train personnel to better monitor the industry condition and supervise problem cases, we believe an independent FSLIC should be able to enter into arrangements to draw, as needed, assistance from FDIC or other bank regulatory agencies.

Although the major problems of insurance fund authority exist in FSLIC, we have some concern about FDIC as well. Several years ago, we observed that FDIC had experienced some difficulty in coordinating its activities with other federal and state authorities. Efforts such as joint examination of some problem national banks with OCC appear to have improved the situation. At the present time it seems to be much less likely that information about a problem institution known to another regulator will be kept from FDIC, or that a chartering agency will keep institutions open that FDIC believes should be closed to keep insurance losses from mounting. Also, FDIC's ability to act independently is evident in the notices of intent to cancel insurance that have been issued by FDIC.[7]

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[7] FDIC gave notice of its intent to cancel insurance to 12 of the 61 national banks that failed in 1987 and 33 of the 123 state-chartered banks that also failed in that year. In all of these instances, chartering officials revoked the charters of the institutions before the procedure to cancel insurance was completed. (In 1987, FSLIC did not issue any notices of its intent to cancel insurance.)

Nonetheless, some legal limitations on FDIC's authority remain. These limitations may be inconsistent with assuring the degree of independence for FDIC that we believe is needed for an independent FSLIC. For example, FDIC officials say that the procedure for cancelling deposit insurance is a cumbersome one. FDIC cannot issue cease and desist orders to national or state member banks, nor can it refuse insurance to a new national bank chartered by OCC or to a new state bank that becomes a member of the Federal Reserve System.

Improve Supervisory Capability and Related Risk-Control Infrastructure

It is now generally recognized that deregulation of financial services requires effective supervision to ensure that individual firms do not mismanage the opportunities to offer new services that deregulation makes possible. Although the Federal Home Loan Bank System and the banking regulatory agencies have taken steps to improve their supervisory capabilities, the task remains unfinished.

Within the private sector, both public accounting firms and appraisers of real property must also play key roles in assuring that depository institutions are not wittingly or unwittingly mismanaged.[8] In this regard, efforts to develop accounting, auditing, and reporting systems to allow regulators to assess the market value of institutions in deteriorating condition should be pursued vigorously. Deposit insurance and other federal regulatory officials should make every effort to hold those involved in the risk-control infrastructure accountable for their actions, and federal and state law enforcement officials and prosecutors also have an important role to play.[9]

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[8] All thrifts and some commercial banks (those where stock is publicly held or traded) are required to have their financial statements audited by outside public accounting firms. Crucial elements of such audits involve evaluation of the internal controls of institutions and of the GAAP value of assets. We have reviewed efforts by FDIC and FSLIC to pursue monetary claims against independent accounting firms in cases where the agencies believed the work the accounting firms performed was negligent. See Bank Regulation: Information on Independent Public Accountant Audits of Financial Institutions (GAO/GGD-86-44FS, Apr. 21, 1986).

Real estate appraisals are important for depository institutions because one measure of prudent lending is that loans not exceed a certain percentage of the appraised value of real estate. Appraisals that are higher than market value can therefore lead to loans being made that will result in losses for the depository institution in the event that the loan goes into default. See Combatting Fraud, Abuse and Misconduct in the Nation's Financial Institutions: Current Federal Efforts are Inadequate, House Committee on Government Operations, U.S. House of Representatives (House Report 100-1088, Oct. 13, 1988), especially pp. 41 to 43.

[9] For a discussion of law enforcement and other activities, see the report by the House Committee on Government Operations cited in footnote 8.

Financial Responsibility of Banks and Thrift Holding Companies for Insured Depository Institutions

In recent years, the holding company structure has become a very common form of ownership for banks and thrifts. This structure allows a corporate organization to expand into a number of activities that are legally and economically separate from those of the insured bank or thrift. Proposals that would allow banking organizations to expand into securities or other nontraditional banking activities often require a holding company format.

Existing laws are intended to ensure that the insured depository institutions are not adversely affected by a holding company affiliate or by actions of the holding company itself. For example, restrictions exist regarding transfers of assets from banks to the holding company or its subsidiaries. An unresolved issue that has a bearing on the integrity of the deposit insurance system is the degree of financial support that holding companies should be required to provide for failing bank or thrift subsidiaries. Although Federal Reserve System policy says that bank holding companies should serve as a source of strength for bank subsidiaries, the degree to which this policy is legally binding has been questioned. It is also not clear exactly how this policy would work with respect to such matters as limits to holding company liability.

Those who oppose special financial responsibility rules for holding companies say this will discourage needed investment in banking organizations. However, the existence of deposit insurance is also a recognition that banks and thrifts are special institutions, different from other businesses. No matter how tightly drawn the laws and regulations may be, there are subtle ways that a holding company can charge costs to a bank or attribute revenue to the holding company and this can affect the ultimate profitability and soundness of the bank—and cause losses to the deposit insurance system.

We believe that it is appropriate to consider rules concerning the financial support responsibilities of bank holding companies to help protect the deposit insurance system from losses in the future. To this end, the Federal Reserve System should draw up a specific proposal to accomplish this objective.

Consistency in Requirements for Banks and Thrifts

Banks and thrifts are linked economically because they compete for the same deposit base and offer many of the same products. Therefore, differences in capital requirements, closure rules, powers, privileges, taxes, holding company arrangements, deposit insurance premiums, or sanctions for undercapitalized institutions can all translate into competitive advantages for one or the other class of institutions. To the extent that the riskier class of institutions can attract insured funds more easily than can the less risky class, the overall exposure of the federal government to deposit insurance losses is increased unless the premiums on the two industries can be adjusted properly. Any attempt to heavily regulate the affairs of one industry but not its competitors may thus prove counterproductive.

We therefore think it is essential from both an equity point of view and from the point of view of protecting the government's financial interest that the industries insured by FDIC and FSLIC be comparably regulated as soon as possible in those matters that are material to deposit insurance risk. Closure rules, similar schemes of capital regulation, and sanctions on undercapitalized institutions could be equalized fairly quickly. However, eliminating all material differences between the two industries and between state-chartered and federally chartered institutions within each industry is likely to take considerably longer to resolve.

Changing the Risks That Deposit Insurance Underwrites

In the last few years, a number of reform proposals that are more far-reaching than those just enumerated have been advocated by representatives of the industry and the regulatory and academic communities. Some of the problems that these reforms, discussed in more detail in appendix IV, are intended to cure are as follows:

- There is no market discipline on the owners and managers of insured institutions. Insured deposits can always be attracted by offering higher rates. So long as the depositors can depend on deposit insurance for their money, they have little incentive to curb risky behavior by depository institutions.
- Deposit insurance to individual institutions is underpriced.
- Risk underwriting by the deposit insurance system is extended because depository institutions or the holding companies that own them are diversifying their activities into more types of financial products.[10]

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[10] One of the most perplexing problems facing the deposit insurance system concerns the powers that are appropriate for institutions that have deposit insurance. Diversification into new product lines provides well-managed institutions with opportunities to earn higher profits, and therefore pay higher interest rates, without taking on excessive risk. On the other hand, permitting diversification into areas of potential risk allows poorly managed institutions to take on an inordinately high degree of risk—as recent experience in the thrift industry makes abundantly clear. Furthermore, diversification increases the number of markets in which institutions operating with relatively low-cost insured deposits compete with those operating with funds raised from other sources. Thus, with diversification, the reach of deposit insurance and the supervisory activities of financial institution regulators extends further into the economy.

- Large institutions that are considered too big to fail received favored treatment.

One set of proposals to deal with these problems seeks to increase market discipline on banks by requiring parties other than the deposit insurance fund to experience losses if institutions fail. These proposals include modified payoffs,[11] co-insurance, reduced deposit insurance limits, and use of subordinated debt to meet higher capital requirements.

Other proposals would price risk by charging risk-based insurance premiums or by imposing risk-based capital requirements that would be intended, respectively, to fully compensate for, or fully buffer the insurance fund from, insurance losses under normal economic conditions. Still another set of proposals would have the effect of forcing insured institutions themselves to take steps to protect the insurance fund from losses. These latter proposals include closing institutions when the market value of an institution's capital hits zero, collateralizing deposits, or allowing insured deposits to be accepted only by what is termed a narrow bank—an entity required to invest only in certain low-risk assets. If these proposals for forcing insured institutions to take steps to protect the insurance fund proved to be successful in controlling risks borne by deposit insurers, we believe they would drastically reduce the cost of operating the deposit insurance system.

Unfortunately, there are practical difficulties associated with all of these proposals. The responses of depositors, depository institutions, and credit markets to any of these reforms is difficult to predict but may have important long-run and potentially damaging consequences for the financial system. For example, the proposals to increase market discipline may introduce types of market instability that have been considered unacceptable in the past, and they also require that depositors and general creditors know a great deal more than they now know about the condition of banks and thrifts.

Risk-based pricing of deposit insurance or capital, and closing institutions when the market value of their capital hits zero, also demand that regulators know more about the current condition of thrifts and banks.

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[11] Modified payouts are a procedure under which uninsured depositors and general creditors receive only their pro rata share of projected asset liquidation values when an institution is closed and arrangements are made to have its insured deposits insured by another institution. For a more detailed explanation of this proposal, see Federal Deposit Insurance Corporation, "Market Discipline and the Federal Deposit Insurance System," Deposit Insurance in a Changing Environment (Apr. 15, 1983), p. III-5.

In addition, these proposals also require deposit insurers or regulatory officials to do things that are likely to prove politically difficult, such as sending out notices of huge insurance premium increases or closing institutions that are still solvent on a GAAP basis.

The proposals for forcing institutions to make provisions for risk through collateralization of deposits or the establishment of a narrow banking subsidiary may affect the patterns of financial flows and interest rates in the economy in ways that are difficult to anticipate. These options may also impair the banking sector's traditional and vital role of serving as a source of liquidity for firms throughout the economy, particularly during periods of financial difficulty.

The complexity of the reform issues and our uncertainty regarding how best to ultimately reform the system leads to the conclusion that more far-reaching reforms must proceed with caution. In moving as quickly as possible to resolve the FSLIC situation, it makes the most sense to take those steps already outlined that build on the current system and that can be done within the existing concept of deposit insurance. With these changes in place, it may then be appropriate to experiment with more fundamental changes in the types of risk that the insurance fund underwrites or in the pricing of risks.

We think it possible, for example, that opportunities may evolve in the future to offer depository institutions options to operate under a different deposit insurance arrangement. For example, a banking organization could be given the option of operating under the current system or, in return for agreeing to fully collateralize insured deposits or place all such deposits in a narrow bank, a banking organization could pay a much lower premium or be granted certain powers that otherwise would not be attainable.

Conclusions

FSLIC's present financial problems as well as recent FDIC losses show clearly that in today's financial environment, insuring about $2.5 trillion in deposits at banks and thrifts can carry great risk. While economic conditions have certainly played a role, the current condition of FSLIC is also the result of other factors that can be changed—for example, enforcing capital adequacy standards. In making changes, the risk management policies for thrifts and banks should be considered together because the two types of institutions compete for the same deposit base and provide many of the same services.

Unless a better balance is achieved between funding arrangements and the risks being underwritten, insurance losses may continue to be very large. The potential threat is illustrated by the existence in December 1987 of 685 undercapitalized thrifts and commercial banks with assets of about $370 billion that were not insolvent but that had less than 3 percent GAAP capital. Further deterioration of these undercapitalized institutions could place great strain on the deposit insurance system.

Current proposals for fundamentally reforming the nature of the deposit insurance system's risk underwriting activities offer the possibility of correcting some of the problems with the existing arrangements and, in some cases, of reducing funding requirements. However, they could also have major effects on the financial flows in the economy, the structure of interest rates, and the stability of the financial system. Because of their potential drawbacks and because their implementation is not necessary to correct the most glaring problems that have bankrupted FSLIC, we believe it is not essential that fundamental reforms be implemented at the same time that action is taken to resolve the FSLIC problem.

Recommendations

To help ensure that the situation that has befallen FSLIC is not repeated within the deposit insurance system, we recommend that Congress take the following steps:

- disengage FSLIC from the Federal Home Loan Bank Board and create an independent insurance function for the thrift industry that has adequate supervisory resources;
- enhance the ability of both an independent FSLIC and FDIC to place stringent controls on improperly operated and/or undercapitalized institutions and to withdraw insurance from such institutions;
- provide FDIC and FSLIC with the authority to raise assessments as needed to be able to meet future insurance costs, over and above whatever special arrangements are worked out for solving FSLIC's current crisis; and
- direct the appropriate agencies to establish consistency in regulation and supervision of banks and thrifts in matters that have a material effect on the government's exposure to deposit insurance losses.

We also recommend that FHLBB, FSLIC, and the bank regulatory agencies

- strengthen capital adequacy requirements and their enforcement,
- improve their supervisory capability, and

- undertake efforts to enhance the effectiveness of the related risk control infrastructure in the private sector.

In addition, we recommend that the Board of Governors of the Federal Reserve System develop a specific proposal for clearly defining holding company financial responsibility for insured depository institutions.

Finally, we recommend that Congress and the deposit insurance agencies, in consultation with federal and state chartering agencies, pursue a more comprehensive reform agenda after FSLIC's funding needs are met and the other recommendations implemented. This agenda should permit some experimentation so that all institutions will not necessarily have to fit into the same approach. For example, institutions could be offered a choice of whether they wanted to collateralize deposits or place their insured deposits in a narrow bank in return for lower premiums or enhanced powers.

Agency Comments and Our Evaluation

FHLBB, FDIC, and the Federal Reserve provided comments relevant to the content of this chapter.

FHLBB disagreed with our recommendation to separate FSLIC from the Bank Board because it believes we failed to justify how such independence improves regulatory oversight and supervision. FHLBB said even if FSLIC is managed independently of the Bank Board, it would have to coordinate with the Bank Board in much the same way as FDIC coordinates with chartering agencies now. FHLBB believes that with separate agencies, the industry could play one agency against the other. FHLBB also said that if in promoting the industry it makes decisions that are biased, it would be critical to correct this bias regardless of the administrative status of FSLIC. Finally, FHLBB said that this particular recommendation does not establish a structure, such as a reinsurance entity, that assures the current depository insurance system problems will not recur.

We believe the failure of the Bank Board over the years to recognize and deal with the risk that insolvent institutions posed to FSLIC is sufficient justification for an independent insurance fund. We recognize that separating the insurance function for thrifts similar to FDIC is not a perfect arrangement because, as we discuss on page 72, FDIC would also benefit from enhanced powers. Therefore, our recommendation to separate FSLIC from FHLBB is coupled with the need to provide the insurance function enough money and authority so it can act to protect itself. From this same perspective of the need for comprehensive action, the recommendation to separate FSLIC from FHLBB in this chapter is one part of our set of recommendations that we believe will help to ensure that the current problems are not repeated.

FDIC strongly supported our recommendations regarding deposit insurance reform, noting that many of our recommendations agreed with those in its recent deposit insurance study. FDIC said the spirit of the reform proposals is to allow the federal deposit insurer to have more independence and to protect the integrity of its fund by functioning more like a private insurance company.

The Federal Reserve agreed with our recommendations to improve financial oversight, describing in some detail its specific efforts to strengthen capital adequacy standards, enhance its supervisory capability, and obtain better information about the market value of financial institutions. (See app. XI, p. 149.) We believe that the actions described by the Federal Reserve are steps in the right direction.

The Federal Reserve said our recommendation to the Board of Governors for a specific proposal to clearly define holding company financial responsibility for insured depository institutions was not necessary. The Federal Reserve said its existing policy statement, although couched in terms of subsidiary banks, clearly affirms the Board's commitment to the principle that a bank holding company should serve as a source of strength to any insured depository institution subsidiary.

While the Board's policy statement may have confirmed the Board's commitment to the "source of strength principle," the issue is far from resolved and, in our judgment, still requires a specific proposal. FDIC discussed this issue in detail in its study Deposit Insurance for the Nineties: Meeting the Challenge, (pp. 229-233). FDIC stated that the validity of the source of strength doctrine has not been tested in the courts, and in recent relevant cases the Federal Reserve has not obtained a judicial determination. We are sympathetic to FDIC's concern on this issue because the extent of holding companies' financial responsibilities has been an issue in recent FDIC assistance actions.

Funding

In chapter 2, we estimated that through 1998 FSLIC will need at least $85 billion more than FSLIC anticipates it will have available. Of the $85 billion, $26 billion is required to help pay for actions taken in 1988, and $34 billion is needed for resolving the cases of the remaining insolvent institutions. The balance represents an allowance for the costs of unanticipated failures between 1989 and 1998, for the payment of interest on funds borrowed to finance insurance losses, and for a reserve that will put FSLIC on a solid financial footing by 1998.

Responsibility for the present condition of the industry and the significant funding shortfall can be allocated to a number of parties. Those who abused thrift institutions and the deposit insurance system through disregard of prudent management standards or outright fraud bear special responsibilities and should be made to pay as much as possible. However, a combination of adverse economic conditions, the unforeseen consequences of legislative changes in depository institutions regulation, weaknesses in federal and state systems for supervising thrifts, and changes in the tax code affecting commercial development have all contributed as well.

Furthermore, the owners of thrifts and their customers have all benefitted financially from the underpricing of deposit insurance for the level of risk regulators permitted. Looking ahead, all depository institutions, depositors, and the public at large have a stake in making sure that the deposit insurance system has the ability to perform its role in protecting deposits, stabilizing markets, and maintaining confidence in the Nation's banking system.

Decisions about who should contribute to the funding solution and the amounts of their respective contributions depend on assessments of ability to pay. But, more fundamentally, the decisions depend on judgments about what is fair. In our view, only Congress can appropriately make this value judgment.

Alternatives for Raising Funds From the Thrift Industry

Potential sources of funding from within the thrift industry include insured thrift institutions, the Federal Home Loan banks, and acquirers of problem thrifts.

Insured Thrift Institutions

Given the size of FSLIC's cash shortfall and the condition of the thrift industry, it is not realistic to expect that the thrift industry will be able to pay all of FSLIC's bills over the next decade. For example, the entire net income of the solvent portion of the industry in 1987 was 0.28 percent of assets (28 basis points) or less than $3 billion. (Over the past decade in periods that have been profitable by historical standards, earnings for the solvent part of the industry averaged about 0.7 percent of assets. At the present time, this percentage applied to the assets of solvent thrifts would yield earnings of about $7 billion.)

Thrift industry representatives point out that they are already contributing to paying FSLIC's bills through the special premium, which FSLIC estimates will provide $19 billion in cash flow if it is continued through 1998.[1] It has also been argued that

- a potential conflict exists in requiring the industry to raise capital levels while shouldering a burden of additional premium payments;
- imposing higher premium payments on insolvent institutions or those that are weakly capitalized would be self-defeating;
- healthy thrifts had no way to prevent the activities by other institutions that have resulted in such high FSLIC losses; and
- the deposit insurance premiums, which are the basis of industry financing, were never intended to cover losses as great as those FSLIC now faces.[2]

Although there are practical limits to how much the thrift industry can pay, it is not correct to assume that any increase in the deposit insurance premium will automatically result in a dollar-for-dollar reduction in net income or capital. Deposit insurance is but one item of expense. In 1987, the regular and special premiums of the industry accounted for about 1.6 percent of its total expenses. As with any unavoidable item of expense that increases in price, thrift institutions, all of which would face the same cost increase with respect to deposits, have choices within limits set by competitive market conditions about whether they charge more for loans; pay less for deposits; or reduce operating expenses through branch closings, cutting salaries, reducing advertising, or by other means.[3]

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[1] The chairman of FHLBB has indicated that the special premium may need to be kept in place for at least 30 years.

[2] For example, see Statement of M. Danny Wall, October 5, 1988.

Other developments could also make it feasible for thrift institutions to pay more to FSLIC than seems apparent simply by looking at industry profitability. As noted earlier, the high rate of interest that many insolvent or undercapitalized thrifts have paid for deposits has a tendency to raise the costs of funds to other institutions. If FSLIC takes control of insolvent institutions, as we suggest, the cost of funds for many healthy institutions will be reduced. This decrease in the cost of funds would enhance the ability of institutions to make further insurance contributions.

Furthermore, FSLIC's financial problem itself may have resulted in the need for some or all thrifts to pay higher rates than would otherwise be necessary to attract funds. The launching of an effort to rapidly deal with insolvent institutions and to restore FSLIC to health could, if successful, reduce or eliminate any tendency for the industry's and FSLIC's problems to increase the costs of funds to FSLIC-insured institutions.

Higher Insurance Premiums

One way to seek to obtain more money from the thrift industry is to raise insurance premiums still further. As a guideline to amounts that could theoretically be raised, we estimate that for each one basis point increase in deposit insurance rates for thrift institutions, as much as $1.5 billion could be raised over the next 10 years, using FSLIC's assumption that industry deposits grow by 7 percent per year.

Each one basis point of premium increase would constitute less than one-tenth of 1 percent of the industry's expenses. Alternatively, expanding the base on which the current deposit insurance premium is levied to include all liabilities could raise a maximum of $9.2 billion more over the next 10 years.[4]

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[3] It has been estimated that about half of the Nation's 85,000 bank and thrift branch offices are losing money because most branches are simply not big enough to make money in today's market characterized by low interest margins. (See a study by Booz, Allen & Hamilton cited in an unpublished paper by Bert Ely of Ely and Co.)

[4] This estimate assumes that total liabilities also grow at an average annual rate of 7 percent. Broadening the base to include total liabilities can be questioned because the system only insures deposits up to $100,000. However, domestic deposits over $100,000 already pay premiums and in practice uninsured depositors and general creditors generally have received de facto protection. Uninsured liability holders also benefit from the stable market environment deposit insurance provides, and the superior claim on assets that some uninsured parties have increases the costs to the deposit insurer if the institution should fail.

The ability to collect higher premiums—as well as the $19 billion FSLIC has already projected for the existing special premium—depends on market forces over which thrifts and FSLIC have but limited control. The rates of interest paid by thrifts to depositors are set in competitive markets as are the rates of interest thrifts charge for loans. If thrifts attempt to recoup higher FSLIC insurance costs by reducing the rate of interest paid on deposits, these deposits may be withdrawn from the industry in favor of FDIC-insured deposits. This would reduce FSLIC's deposit base and perhaps introduce liquidity problems for some institutions. Similarly, if thrift institutions attempt to raise their loan rates, customers may seek loans elsewhere. Finally, in response to higher insurance rates, healthy thrift institutions themselves might seek FDIC insurance unless constrained from doing so as they currently are.

The above discussion illuminates a dilemma associated with the decision about how much money to raise from the thrift industry. The desire to be fair and avoid the setting of a dangerous precedent dictates that thrifts be required to contribute to the financing shortfall. But, in funding the financing shortfall, it would be foolhardy to damage healthy, well-managed thrift institutions and/or further exacerbate FSLIC's problems.

A Good Company/Bad Company Reorganization of FSLIC

One approach to obtaining a thrift industry contribution that we believe can overcome the difficult trade-off outlined above involves reorganizing an independent FSLIC to create two separate funds that can be termed "good company" and "bad company" funds. The good company fund would consist of the thrifts that initially meet a minimum standard of financial soundness—perhaps a GAAP capital level of at least 3 percent of assets.[1] (See table 6.1.) The bad company fund would contain all insolvent and undercapitalized institutions, including all institutions placed in receivership as suggested in chapter 4. Institutions initially qualifying for the good company fund but not meeting industry minimum capital adequacy standards would be given a limited period of time to reach the adequate level.

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[1] The level of capital sufficient to initially qualify for the good company fund could be less than the regulatory minimum capital adequacy standard for the industry.

Table 6.1: Example of the Distribution of Institutions in a Good Company/Bad Company Reorganization of Fslic

	Number	Assets	Total Deposits
Composition of the good company fund: Thrifts with 3-percent or greater GAAP capital	2,207 (70%)	$856 (68%)	$628 (67%)
Composition of the bad company fund: Thrifts with less than 3-percent GAAP capital[a]	940 (30%)	395 (32%)	305 (33%)
Totals[b]	**3,147 (100%)**	**$1,252 (100%)**	**$933 (100%)**

Note Based on information as of December 31, 1987

[a] From table 2.1

[b] Columns may not add due to rounding

The good company fund would be set up in accordance with the risk management policies described in chapter 5. That is, the fund, with a board of directors independent of FHLBB, would operate under revised policies regarding enforcement of capital adequacy guidelines, sanctions on undercapitalized institutions, closure of insolvent institutions, and enhanced powers for the insurance agency to protect the integrity of the good company fund. As a result of these different operating rules, insurance losses in the good company fund could be expected to be quite low.

The good company fund would need to be capitalized with sufficient reserves to place it on a solid financial footing. Arrangements would also have to be made to cover the insurance losses of the bad company fund, with as much financing as possible provided by the thrift industry. The following section shows how this could be done.

Financing of the Good Company and Bad Company Funds

Capitalization of the good company fund could be done in several ways. For example, it could be accomplished in a manner similar to the NCUSIF recapitalization in 1984. Under this arrangement, which is described in more detail in appendix VI, each institution insured by the good company fund would make a capital contribution to the good company fund equal to 1.0 percent of insured deposits. By investing this capital contribution in government securities, the fund would earn interest income.

In 1989, if the good company fund was comprised of the firms with GAAP capital of at least 3 percent, the initial one-time capital contribution would be about $8 billion.[1] As institutions grow, they would continue to make capital contributions to maintain the 1 percent of insured deposits relationship. If deposits grow at the 7-percent-per-year rate FSLIC projects, and all thrift industry deposits are in good company fund institutions by 1998, the balance in the capital contribution account at that time would be $18 billion.[7]

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[1] If desired to minimize the initial burden placed on insured institutions, the 1-percent contribution could be phased in over several years. However, a delay in making the capital contribution would reduce the interest income of the fund.

Institutions in the good company fund could continue to pay insurance premiums, but we assume that they would be no higher than the existing regular assessment of one-twelfth of 1 percent of deposits. Given the capital contribution noted above, the existing special assessment could be eliminated. A working capital account (that also earns interest) within the good company insurance fund would be built up through accrual of interest on the asset contribution and through premium contributions. Insurance losses occurring in good company institutions would be paid from the working capital account, as would all administrative expenses. When the level of the working capital fund plus the 1-percent capital contribution reached a predetermined level (such as 1.3 percent of insured deposits), any excess money in the fund after expenses and other costs could, for a period of time (such as through 1998), be paid to the bad company fund to help pay the expenses of resolving the cases of insolvent thrifts. Thereafter, it could be rebated to good company thrifts, although arrangements would have to be made for interest payments on the remaining years of the 30-year FICO bonds.

An example of the financing of a good company FSLIC reorganization based upon the preceding discussion is summarized in table 6.2. Over the 10-year period, premium income and interest on reserves would provide the good company fund with about $23 billion in revenue. After deducting estimated insurance losses between 1989 and 1998 (assumed in this example to be $5 billion), administrative expenses, and working capital reserves, about $10 billion would be available in this example for payment to the bad company fund.

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[7] The FHLBB currently has the authority to require insured thrifts to deposit 1 percent of their deposits with FSLIC to be used for liquidity purposes. FSLIC must pay interest on these deposits which amount to a loan to FSLIC.

Table 6.2: Example of Good Company Revenues and Uses of Funds for the 10-Year Period 1989 Through 1998

Dollars in billions	
Revenues	
Premium income (8.3 basis points)	$11.4
Interest earnings on reserves[a]	11.5
Total	**22.9**
Uses of Funds	
Administrative expenses	2.4
Assumption regarding insurance losses	5.0
Build up of working capital reserves	5.3
Total	**12.7**
Amount that can be paid to the bad company fund to help resolve problem thrift cases	10.2

[a] Reserve balances on which interest is earned result principally from capital contributions of 1 percent of insured deposits, which are not counted as fund revenues in this example. Interest is also earned on the buildup of working capital reserves.

Under this reorganization, the finances of the bad company fund would be the same as FSLIC's forecast through 1998 discussed in chapter 2, except for our higher estimate for resolving insolvent cases and for the removal of the revenues and expenses associated with the institutions moving to the good company fund. All obligations and liabilities incurred by FSLIC up to the date of the reorganization would remain the responsibility of the bad company fund. The most important impact of the reorganization is that most of the premium revenue FSLIC expected to have to resolve problem cases would no longer be available because healthy firms will have moved to the good company fund. A summary of the bad company finances is shown in table 6.3.

Table 6.3: Summary of Bad Company Financial Needs: 1989 Through 1998

Dollars in billions

	Change in funds needed for the bad company fund compared to FSLIC's 1998 cash flow estimate
Additional funds to pay for costs of cases acted on in 1988	+ $26
Additional expenses for resolving approximately 350 remaining insolvent cases	+ 34
Loss of regular and special premium revenue as a result of institutions transferring to the good company fund	+ 29
Reduced administrative expense for the bad company fund	- 2
Subtotal	+ $87
Contribution from the good company fund to help pay bad company expenses	- 10
Net additional amount needed from federal contribution or other sources	$77

Note: Bad company finances are the same as the FHLBB's projection for FSLIC, discussed in chapter 2, modified by the following two considerations

(1) GAO's estimate of the cost to resolve and finance insurance losses presented in chapter 2

(2) A good company/bad company reorganization of FSLIC as contained in the example of tables 6.1 and 6.2

The amounts shown in the table represent additions to or subtractions from FSLIC's cash flow projection summarized in table 2.3. This projection includes payment of interest on FICO bonds through 1998.

An estimate of reserves for the bad company fund has not been included because the institutions in this fund will either be closed or will eventually transfer to the good company fund (or perhaps to FDIC) by way of merger or rehabilitation.

We estimate that the additional funds the bad company fund will need beyond what is included in FSLIC's projection will come to $87 billion—$26 billion unfunded costs of actions taken in 1988, $34 billion for action on other insolvent cases, plus $27 billion in revenues lost (net of savings in administrative expenses) due to the good company fund financing arrangements.[a] Of the $87 billion, $10 billion could be paid from a contribution from the good company fund. This leaves a deficit of approximately $77 billion to be made up by a federal contribution or other sources.[9]

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[a] This $87 billion needed for the bad company fund is consistent with, but should be distinguished from, the overall $85 billion in additional funds for insurance expenses and reserves we estimate FSLIC will need.

This example of good company/bad company financing over the next decade generates $10 billion more revenue from the thrift industry in the form of contributions from insured institutions and interest on reserves than is the case with FSLIC's July 7, 1988, cash flow projection.[10] Although the amount of the capital contribution received by 1998 would be slightly less than the special premium that otherwise would be collected, the capital contribution is paid in sooner and hence is able to earn interest that benefits the insurance fund. Nonetheless, the good company/bad company approach has the potential for not adversely affecting the condition of the industry as much as continuing the special premium for up to 30 years or even increasing it. The reason for this is that if losses in the good company fund are low, interest on the contributions eventually would serve to reduce future insurance premiums. The success of the good company fund depends, however, on whether a more

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[9] A decision will also have to be made about how interest on the FICO recapitalization bonds will be paid after 1998.

[10] Under this good company/bad company reorganization example, the total amount of money obtained from insured institutions and insurance fund reserves for the 11-year period 1988 through 1998 would amount to about $44 billion—the sum of the capital contribution, premiums, and interest on reserves as follows:

Premium collections from all institutions in 1988 and from institutions in good company and bad company funds in 1989 and subsequent years	$14.4
Interest on reserves in the good company fund	11.5
Capital Contributions to establish and maintain reserves	17.8
	$43.7

FSLIC's cash flow projection for the period 1988 through 1998 assumed about $34 billion would be obtained directly or indirectly from the industry from premiums and interest earnings on reserves. The amounts are as follows:

Regular premiums	$13.0
Special premiums	19.4
Interest on reserves	1.2
	$33.6

To simplify the comparison, both calculations assume that deposits will grow in the industry at a rate of 7 percent per year.

rigorous approach to regulating and supervising the good company fund is able to keep insurance losses low.[11]

Permitting the Migration of Healthy Thrifts to FSLIC

Under this option, healthy thrifts that meet FDIC's qualifying criteria should be allowed to choose to migrate to FDIC upon paying some combination of an exit fee and a capital contribution to FDIC. The total cost of the fee and contribution, after taking into account FDIC premium assessments, should be equivalent to the cost of staying in the good company fund. One advantage of this approach is that as long as costs to healthy institutions were similar, the decision to migrate to FDIC versus migrating to the good company FSLIC fund would represent a market test of the value of a thrift industry charter and of the strength of thrift institutions' belief in the need for continuation of a specialized housing lender industry.

If a sufficiently large number of healthy thrifts migrate to FDIC either right away or after they have been able to bring their capital up to FDIC standards, the number of thrifts comprising the good company fund may not allow for enough risk diversification to provide a sound basis for a deposit insurance fund. If this occurs, it might be appropriate at that point to take steps to consider consolidating FDIC and the good company thrift fund since business decisions taken by individual thrifts would already have largely achieved that result.

Federal Home Loan Bank System

The 12 Federal Home Loan banks, which make up the System, are viewed in capital markets as having agency status, which makes it possible for them to raise money at favorable interest rates. They are an important source of funds for member institutions and are responsible for carrying out many important public functions, such as supervision of all federally chartered thrifts.[12] The banks are owned by the member thrift institutions. Each member institution is required to own stock in proportion to the level of the mortgage obligation holdings and the System advances it has received. In 1987, the banks, which have a combined capital/asset ratio of 8.9 percent ($13.7 billion/$154 billion), earned a profit of more than $1.3 billion, which allowed them to pay cash and stock dividends of over $1 billion. The System played a role in the recent recapitalization of FSLIC by providing the funds to purchase zero coupon bonds used to back the payment of principal on the FICO bonds.

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[11] If losses in the good company fund are higher than expected, interest earnings on reserves would be reduced and insured institutions would also be expected to contribute additional amounts to maintain their contribution at a level of 1 percent of insured deposits.

[12] In 1987, the System raised $70.4 billion (much of it to refinance outstanding obligations) in consolidated bonds and discount notes sold by the Office of Finance, the fiscal agent for the System. Advances to member thrift institutions at the end of 1987 totaled $116.8 billion.

It may be possible to find other ways to devote some or all of the System's capital and earnings to help solve FSLIC's funding needs. Although the System represents one of the strongest central credit facilities in the world, tapping a significant portion of its resources has the drawback of reducing the earnings or assets of the member thrifts that own stock in the banks. In other words, such steps would have effects similar to raising insurance premiums and could jeopardize the solvency of already weak thrifts and damage the competitiveness of healthy thrifts.

One way to involve FHLBS would be to expand the existing $10.8 billion recapitalization program. If FHLBS purchases Treasury zero coupon bonds to make provision for the payment of principal on FICO bonds, the cost to FHLBS depends upon the maturity of the bonds. At a 9 percent Treasury rate of interest, the cost of a 30-year zero coupon bond is about 7.1 percent of the amount of the principal payment that will be due on a FICO bond in 30 years. Thus, for each $10 billion in 30-year bonds sold by FICO, the cost to FHLBS would be about $710 million. If 15-year bonds at a 9 percent interest rate were used instead, the cost to FHLBS of the 15-year zero coupon bonds would be about 27 percent of the amount of the principal due in 15 years. Thus, for each $10 billion in 15-year bonds issued by FICO, the cost to FHLBS would be about $2.7 billion.

The problem with this approach to recapitalization is the payment of interest. In total, the interest payments far exceed the cost of FHLBS's zero coupon bond purchase. If FICO issued $10 billion in bonds paying 10 percent interest annually (the FICO rate has been about one full percentage point above the Treasury rate for comparable maturity), FSLIC or some other party would have to make annual interest payments of $1 billion for the length of the maturity of the bonds.

Quite apart from possibilities for paying for FSLIC's losses, the System's borrowing power may be useful in advancing funds to FSLIC or to insured institutions to facilitate the resolution of problem cases. Funds for such advances could come from the System's own resources or from its ability to access a $4 billion credit line with Treasury. However, the interest costs on System borrowing will be higher than if the borrowing were accomplished directly from the Treasury.

Liberalize the Laws on the Acquisition of Thrifts

FSLIC has authority to arrange mergers with virtually any type of institution willing to acquire a failing thrift. However, there are other constraints on the acquisition of thrifts which, if removed, might attract additional capital that could correspondingly reduce the amount of the $85 billion in funding that has to be raised from other sources. For example, under the provisions of the Bank Holding Company Act, banks or bank holding companies that acquire a thrift can only exercise thrift powers that are consistent with the more limited powers permitted for bank holding companies. Similarly, FHLBB generally has not allowed securities firms to acquire and use the full powers of the thrifts.

Although we do not know how significant the potential contribution to FSLIC funding needs might be, there is little question that if the range of product powers were expanded to provide an inducement for banks and others to acquire failing thrifts, the prices paid for those thrifts would rise. However, efforts to consciously enhance the value of the thrift charter would be counter to the recommendation we made in chapter 5 to reduce the differences between banks and thrifts. Moreover, major public policy issues on the uses that may be appropriately made of insured deposits have recently been debated by Congress. Until these issues are resolved, any relaxation of constraints on acquiring thrifts should be held in abeyance.

Financial Participation by the Federal Government

We believe that the need to solve the FSLIC problem as quickly and cheaply as possible is of such great importance that federal funds should be used to the extent necessary to accomplish this. Government policies have in various direct and indirect ways contributed to the FSLIC problem and there is a public good aspect to deposit insurance and financial market stability. There is ample precedent for federal funding of economically depressed sectors and institutions. Also, using federal funds is preferable to other schemes meant to hide or put off the cost.

However, federal participation should be conditioned on adoption of actions that change the way insolvent thrifts are currently resolved as well as actions that improve the quality and consistency of regulations to better manage risks and control losses in the future. Federal participation should also be conditioned on the existence of appropriate controls over expenditures of funds to assure that the government's interests and those of taxpayers are protected.

The amount of federal funding needed to pay insurance losses depends on decisions about the use of alternative sources of funding. The fewer the other sources of funding, the greater the commitment of federal funds will need to be. For example, if a good company/bad company reorganization of FSLIC is done and financial flows such as those discussed earlier materialize, then the remaining cash shortfall that would need to be financed by the federal government would be about $77 billion (see table 6.3).

Types of Federal Assistance That Could Be Provided

There are two types of federal assistance that could be provided to help restore the deposit insurance system to financial soundness. The first is helping to meet the funding shortfall needed to cover insurance losses and restore FSLIC to financial health. Federal funds for this purpose could be provided directly to FSLIC by purchase of stock in FSLIC or by other proposed methods that are, practically speaking, no different than federal outlays.

- The Federal Reserve System could be authorized to pay interest on the reserve accounts that thrifts and other depository institutions are required to keep at Federal Reserve banks, with the payment diverted to FSLIC until such time as the deposit insurance financing needs have been met. These payments would amount to about $3 billion per year.
- The Federal Reserve could pay some or all of its operating profits, currently running about $17 billion per year, to FSLIC rather than to the Treasury. Profits would be about $3 billion less annually if the Federal Reserve were also paying interest on deposited reserves.

Although we have not examined these suggestions in detail, we are concerned that their basic purpose is principally to mask the degree of the federal government's financial commitment that is likely to be involved in resolving the FSLIC situation. If these or other indirect measures for obtaining federal financing are adopted, they should be justified in their own right as sound policies, rather than as convenient financing expedients.

A second type of federal assistance would be to provide a source of borrowing so that FSLIC can move much more quickly to resolve problems. If the goal of acting to resolve all insolvent cases within 3 years is to be met, a high volume of short-term liquidity loans may also be needed to help with liquidations or to cover deposits withdrawn from institutions that have been taken over by FSLIC and are in the process of being closed. The Treasury can provide the cheapest, most flexible source of credit available.

To the extent that federal money is used, we recommend an on-budget approach that fully discloses the funding and outlays that are involved, even if this requires raising the Gramm-Rudman-Hollings deficit reduction targets. We also think that a restructured federal budget along the lines we have proposed elsewhere would better highlight the financing of FSLIC and similar business-like enterprises.[11]

To assure adequate controls of spending to protect the taxpayers' interests, we also believe it would be appropriate to create a special control board if federal funds are provided. This board, which should include the Secretary of the Treasury and possibly the Chairman of the Board of Governors of the Federal Reserve System, would be empowered to review spending plans before funds would be released. The board would continue to exist until all of the presently identified problem cases had been resolved.

To restore FSLIC to financial health with a significantly smaller federal financial commitment than $75 to $80 billion, other sources of financing outside of the thrift industry will have to be considered. These sources include other depository institutions and depositors themselves. Because of their size, the banking industry or depositors are the only other likely industry sources that could make major contributions to financing the shortfall.

Banking Industry

Clearly, the FDIC-insured banking industry is not responsible for the problems of the thrift industry or its insurer. In fact, many believe that the banking industry has been significantly damaged due to the behavior and regulation of the thrift industry.

Furthermore in past federal rescues of troubled individual institutions or economic sectors, no private sector funding has been obtained from anyone other than the assisted entity(s). For example, in the Chrysler Corporation rescue, Ford and General Motors did not provide funds. In the recent Farm Credit rescue, funding was not obtained from its commercial bank competitors. Nor did other cities contribute to the New York City rescue. In these and other cases, financing to resolve the problem came from the distressed entity and/or from general taxpayer revenues on the grounds that the problem was national in scope, a solution was in the national interest, and general taxpayer financing distributed the financial burden most widely so that individual contributions were minimal.

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[11] Financial Management Issues, (GAO/OCG-89-7TR, Nov. 1988), pp 10-12.

Nevertheless, in view of the fact that both industries offer the same deposit products in competition with one another, FDIC-insured banks stand to benefit from prompt resolution of the FSLIC problem. For this reason, a contribution from the banking industry may be worth considering. The erosion of confidence in thrift industry deposit offerings has resulted in increased rates, which many believe have increased the rates banks must pay to attract deposits. Furthermore, as already noted, changes in, and equalization of, risk management policies could significantly enhance the ability of banks to compete for insured deposits. From the federal government's perspective, any contribution by the banking industry would reduce federal outlays needed to meet the funding shortfall. However, like the dilemma that exists for deciding on what the thrift industry can pay, if a contribution is sought from the banking industry it is essential that it not adversely affect the competitiveness or viability of FDIC-insured banks.

We believe a banking industry contribution to financing resolution of the FSLIC problem should only be considered if the following conditions are met:

- Significant steps are taken to equalize regulation of the two industries with regard to matters that have a material affect on deposit insurance risks: powers, capital requirements, closure rules, closure processes, the quality of supervision and oversight, and access to FHLBS advances to finance housing lending.
- Appropriate controls are in place over how contributions to financing are spent.
- Any thrift institutions that are resolved through merger or rehabilitation must be adequately capitalized from their inception to eliminate the possibility that banks would have to compete with undercapitalized thrifts.

These conditions represent changes that need to occur regardless of whether there is a contribution from FDIC-insured banks. They are important in their own right in restoring FSLIC to a solid financial footing, and ensuring that the mistakes of the past are not repeated. But, if a contributions were to be sought from FDIC-insured banks, the government would also have a special responsibility for ensuring that bank contributions were as well spent as contributions by taxpayers.

As is the case with thrifts, we have not fully assessed the banking industry's ability to make contributions to meeting the financing shortfall. As a guideline to amounts that could potentially be raised, we estimate that for each one basis point of premium levied on the domestic deposits of FDIC-insured banks, a total of $3.5 billion could be raised by 1988. Increasing the assessment base for banks to include all liabilities and charging the current one-twelfth of 1 percent deposit insurance premium could raise about $12.6 billion more through 1998 than what would be raised by charging a similar assessment against total deposits.

Like thrifts, the amount of additional insurance expenses FDIC-insured banks can be expected to pay without damage to healthy institutions depends upon earnings, ability to shift insurance costs to customers, and ability to reduce other items of expense. It is important to note in this regard that if a contribution is sought from both banks and thrifts that roughly equalizes their costs of insurance, the ability to pass those costs on to customers and therefore their ability to effectively compete for deposits would also tend to be more equivalent. Larger commercial banks do, however, have the additional problem of overseas competition with foreign banks.

Depositors

Depositors benefit directly from deposit insurance and they already indirectly bear a portion of the costs of deposit insurance assessments in the rates of interest that they earn. Though they bear no responsibility for the excesses or mistakes of thrift institutions managers, they have benefitted from past insurance arrangements, and they will benefit from efforts to restore the system to health. For these reasons and because it has become all too obvious that rates charged for deposit insurance by FSLIC have been too low for the level of risk that regulators have permitted, seeking contributions directly from depositors is another possibility.

Although a fee would no doubt be initially levied on the institution, legislation imposing the fee could specify that the charge had to be explicitly identified as a deduction from the rate of interest that otherwise would be paid on the account.[14] Because of competitive considerations, a depositor fee would probably need to cover all depository institutions, and perhaps as well the deposit-like products of certain other institutions. Levying a depositor fee only on thrifts would cause account balances to be transferred to banks or other institutions offering the same or similar deposits. At a minimum, therefore, such a fee would have to be levied on banks, thrifts, and credit unions. Consideration could also be given to imposing a fee on checking-like money market funds offered by broker dealers that are close substitutes for deposits in depository institutions.

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[14] In practice, the ultimate incidence of the fee would be hard to determine because institutions may reduce other costs to depositors to remain competitive.

A depositor fee levied across banks, thrifts, and credit unions has the potential for raising considerable sums of money. Each one basis point of fee could raise as much as $5.2 billion by the end of 1998. This means, for example, that a depositor fee of one-eighth of 1 percent (12.5 basis points) could provide about $65 billion through 1998. For each one basis point fee, the average depositor would pay about $1 per year in lost interest income (based on an average account balance of $9,500), while a depositor with a $100,000 account balance would pay $10 annually.[15] Another $.5 billion might be obtained from each basis point levy on checking-like accounts offered by the securities industry.

The principal attribute of using a broad-based depositor levy to fund the cash shortfall is that it would not compete with other budget priorities, while a solution funded with general revenues would.

There are, however, drawbacks from trying to raise significant amounts of money in this way. There is a fairly strong positive relationship between income levels and account balances in depository institutions. However, in contrast to income tax rates which are progressive, a flat rate levy on depositors would tend to be regressive, i.e., lower-income depositors would pay a higher amount of tax relative to their income than would higher income depositors. This problem could be moderated by exempting deposits under a certain amount from additional charges, but this would reduce revenue potential. A second drawback is that, in a competitive environment, singling out deposits for a special fee is likely to encourage development of close substitutes for deposits that are able to avoid the fee. Such efforts, designed solely to get around the consequences of a fee, do not necessarily contribute to the overall efficiency of the financial system. Also, depositors with higher income and account balances are most likely to be in a position to avoid charges by placing money in such nondeposit instruments.

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[15] The effective burden of the fee would change as interest rates changed. The lower interest rates fall, the greater the burden of a flat rate fee and therefore the greater the incentive to shift deposits to another type of institution. Reduction in interest earnings from the imposition of a depositor fee would also reduce depositor tax liabilities, to some extent resulting in a decrease in tax revenues to the government.

Conclusions

There is no way to determine precisely how much money FSLIC will ultimately need. We estimate, however, that financing insurance expenses and adequate reserves will require at least $85 billion more than FSLIC projects that it will have available.

Decisions about who should contribute to the resolution of the thrift industry crisis depend on assessments of ability to pay and cross industry competitive consequences, and on judgments about what is fair. Judgments regarding what is fair are bound to differ, further complicating decisions about how funding a resolution of the thrift industry's problems should be accomplished.

We have not made an assessment of the full extent of the thrift industry's ability to pay more than the $34 billion in contributions through 1998 (premiums plus interest on reserves) currently assumed in FSLIC's projection. We believe, however, that to the extent possible, additional contributions from the thrift industry should be sought in a way that does not jeopardize the viability of healthy thrift institutions.

In our view, a good way to accomplish this result is to reorganize FSLIC into separate good company and bad company funds. The good company fund would be financed through capital contributions and premium assessments. The bad company fund would be financed out of (1) FSLIC's existing revenue sources (less the premiums that would have been paid by institutions moving to the good company fund), (2) payments by healthy thrifts to meet their mutual insurance responsibilities, and (3) contributions from the federal government and possibly other sources outside of the thrift industry. Well-capitalized thrifts that can meet FDIC's requirements should also be given the option of joining FDIC at a cost equivalent to that incurred in joining the good company thrift fund.

The arrangement cannot be expected to make a significant contribution to meeting the $85 billion cash shortfall. Unless contributions are sought from the banking industry and/or depositors, the government on behalf of taxpayers probably will have to provide $75 to $80 billion in funds. A contribution of this magnitude can be justified because the thrift problem is national in scope and government policies contributed significantly to its occurrence. Whatever financing plan is settled on, it should provide the majority of funding within the next 3 years to enable institutions to be resolved quickly.

While the banking industry bears no responsibility for the thrift industry's problems, it stands to benefit from both their quick resolution and the changes to regulations that will improve risk management and equalize the basis for competition between the two industries. Therefore, a contribution from FDIC-insured institutions or depositors of all insured institutions may, under some circumstances, be justified. But, the decision depends on value judgments that only Congress can make.

Recommendations

We recommend that Congress take the following actions:

- Adopt a funding plan that can provide at least $85 billion to pay for insurance losses and to restore FSLIC's reserve. (Because of the uncertainties associated with the condition of insolvent thrifts, the actual amount can later be increased or decreased based on experience.)
- Seek funds from the thrift industry through creation of good company and bad company funds under an independent FSLIC. The good company fund reserves should be established through capital contributions by thrifts.
- Allow well-capitalized thrifts the option of joining FDIC at a cost that is equivalent to joining the good company FSLIC fund.
- Require thrifts joining the good company fund or FDIC to make equivalent contributions to meeting the expenses of the bad company fund.
- Authorize FSLIC to undertake short-term borrowing for liquidity purposes to enable FSLIC to move as quickly as possible to resolve problem cases.
- Recognize in budget totals any federal funding that may be provided.
- Establish a special board to protect taxpayers' interest by overseeing the expenditures of any federal funds provided to resolve thrift cases over the next several years.

Agency Comments and Our Evaluation

The Federal Reserve complimented our presentation of the funding options, agreeing that the issue is best decided by Congress. Treasury commented on a statement in our Conclusions section, where we said that a large taxpayer contribution "can be justified because the thrift problem is national in scope and government policies contributed significantly to its occurrence." Treasury believed the statement was incomplete, citing numerous other contributing factors that it believed should be mentioned: high interest rates, technological innovations, commodity disinflation and an economic downturn in the Southwest, expanded state-authorized asset powers, imprudent thrift managers, and fraud. We agree with Treasury that these other factors contributed, and we discussed them at the beginning of the chapter and as applicable in our discussion of the rationale for contributions from industry sources.

Chapter 7

Merger of the Insurance Funds

In the preceding chapters we pointed out that three things need to be done to solve the problems associated with FSLIC's insolvency and ensure that they are not repeated: (1) adopt new procedures to take control of insolvent institutions as soon as possible, (2) better manage the deposit insurance system's exposure to risk, and (3) provide enough money to resolve problem cases and establish adequate insurance fund reserves.

A merger of the insurance funds alone cannot accomplish any of these objectives, although it could provide a stimulus for developing an appropriate plan of action. However, in view of the drawbacks associated with undertaking an immediate merger of the funds, we believe it makes more sense to accomplish the objectives set forth above by reorganizing FSLIC and other means.

Before considering whether to merge the deposit insurance system, Congress first should implement changes to establish comparable regulatory ground rules for banks and thrifts, ensure that banks and thrifts are financially sound, and decide whether there is a need for specialized housing finance institutions. After these actions have been accomplished, merger could then be considered as part of an overall effort to further assure the integrity of the deposit insurance system and to simplify the regulatory structure for the depository institutions industry.

Impact of Merger on Taking Control of Insolvent Thrifts

In chapter 4, we concluded that FSLIC needed to take control of insolvent thrifts as soon as possible. Congress may, however, wish to further strengthen the administrative capability that applies to thrift deposit insurance by merging the administrative functions of FDIC and FSLIC. By merging the administrative functions, the combined resources of the two agencies—including FDIC's greater in-house capability for managing the case resolutions process—could be used for deciding the true condition of problem cases, managing the case resolution process, and monitoring the complex merger agreements that have already been arranged.

We also pointed out that merger of the funds is not necessary for achieving the resource gains and independent perspective that are needed to change the way problem thrift cases are resolved. FSLIC could draw on the personnel resources of FDIC or other federal regulatory agencies without merger, and independence could be achieved if FSLIC were reorganized with its own independent board of directors.

Risks and drawbacks associated with full merger of the insurance funds also make the non-merger or administrative merger alternative more attractive at this time. For example, if the insurance funds are merged, there is a risk that overall confidence in the nation's banking system would be adversely affected because the public may assume that the thrift industry's problems are being transferred to the banking system. Also with a full merger, all of the pressures that have and will be associated with resolving thrift industry cases could be transferred to FDIC, at a time when it needs to devote attention to problems in the banking system.

Another possible drawback is that full merger of the funds could be taken as a substitute for basic policy changes that need to be made. For example, existing forbearance policies need to be changed irrespective of whether the funds are merged.

Impact of Merger on Risk-Management Improvements

The risk-management improvements we discussed in chapter 5 to keep the FSLIC situation from recurring involve changes in laws and regulatory practice. Many of these changes have little to do with the subject of merger per se. For example, Congress can legislate similar capital requirements for both industries and can set rules for both thrift and bank holding companies regarding obligations to support failing depository subsidiaries. Also, FDIC and a reorganized, independent FSLIC could both be given powers to assert greater supervisory and regulatory control over undercapitalized and failing institutions.

The contributions to risk management that merger of the insurance funds might be able to make fall into two areas: equalizing the treatment of thrifts and banks and speeding up the implementation of policy changes. However, in our view, satisfactory results can also be accomplished in these areas without merging the funds.

Equalizing the Treatment of Thrifts and Banks

As we have noted, banks and thrifts are linked economically through their competition for the same insured deposit base and provision of many of the same services. This means that risk management policies adopted by only one of the industries affect the competitive position of the other and may be counterproductive in controlling the overall risk exposure of the federal government.

The most straightforward approach to resolving the differences in federal regulation and oversight would be to combine the entire federal regulatory apparatus for the banking and thrift industries, not just the insurance function. This would assure a common approach to federal regulation of the two industries without the uncertainties and possible failures associated with coordination of regulation.

To combine functions while making minimum changes to the existing regulatory structure, the chartering function for federal thrifts could be assigned to OCC, and FDIC could be given responsibility for supervising state-chartered thrifts. FDIC already supervises the state-chartered, nonmember commercial banks and state-chartered savings banks that it insures. Consolidation of the chartering and supervision functions should make it easier to eliminate all regulatory distinctions between federally chartered thrifts and banks within a set period of time.

In combining functions, FHLBB need not necessarily be abolished, but it should no longer retain regulatory and supervisory responsibilities. Instead, it should concentrate exclusively on housing finance if this is considered necessary. Advances to institutions engaged principally in housing finance could then be made available to any qualifying depository institutions including commercial banks.

We favor efforts to resolve structural issues within the banking and thrift industries. However, we think some of these issues are similar to those discussed in chapter 5 concerning more far-reaching deposit insurance reform. We are most concerned that debate over whether to consolidate the regulatory structure could delay efforts to fund FSLIC's resolution costs and to improve risk management in the deposit insurance system.

It may take a considerable amount of time to reach a consensus about both the future of specialized housing lending institutions and what combination of powers now held by thrifts and banks will be appropriate for insured depository institutions in the future. Furthermore, differences in the regulation and supervision between federally and state-chartered thrifts and banks would have to be worked out. Thus, while we support efforts to simplify the regulatory structure, they are not necessary to correct the most glaring problems which might cause FSLIC's situation to be repeated.

Rather than proceeding right away with a full merger of the funds, we think it makes more sense to reorganize FSLIC, make it independent of FHLBB, and charge it with establishing a fund for thrifts which is run as closely as possible to the one for FDIC-insured institutions with respect to certain essential matters. These essential matters include financial reporting standards, enforcement of capital rules, and sanctions on poorly capitalized institutions. This approach would avoid the inherent problem associated with merger discussed above—namely, public perception of risk to the banking industry if the funds were merged right away. When parity between the two funds has been achieved and questions about the appropriate structure of depository institutions have been resolved, giving consideration to full merger of the funds would be more appropriate.

Accelerate Implementation of New Risk Management Policies

At the rate FSLIC has been acting on cases, it will take some time before all insolvent and weak institutions can be resolved. It may therefore not be possible to credibly implement and enforce new rules, especially in areas such as capital adequacy and closure policy, so long as institutions that cannot comply with the rules are able to continue to operate within the same regulatory and insurance system.

Full merger of the funds could help to accelerate implementation of new risk-management policies within the thrift industry as long as the merger decision is accompanied by changes in policy designed to isolate problem institutions from the rest of the industry as soon as possible. Isolation of problem thrifts can, however, be accomplished within the thrift industry itself if FSLIC were reorganized into good company and bad company funds independent of FHLBB as outlined in chapter 6.

Some of these same results can also be accomplished if thrifts meeting FDIC standards are allowed to switch to FDIC. CEBA imposed a moratorium on switching which is now set to expire in August 1989. If switching were permitted, thrifts that meet FDIC's standards could then switch to FDIC after meeting their mutual insurance responsibilities to FSLIC through payment of an exit fee or similar arrangements. If many institutions switched, this would result in a de facto merger of the insurance funds for FDIC-insured banks and well-capitalized, viable thrifts.

Impact of Merger on Funding Considerations

In chapter 6, we estimated what the order of magnitude for contributions to resolve the thrift industry problem might be if only the thrift industry and the federal government were involved in funding FSLIC's cash shortfall. We said that, without a contribution by other financial services industry participants, the government could anticipate a contribution of about $75 to $80 billion. We pointed out that under certain circumstances, a contribution from the banking industry or its depositors might be considered to reduce the funding that would have to be supplied from general revenues of the government. However, this is a value judgment only Congress can make.

The most obvious way that an insurance fund merger would help with meeting FSLIC's expenses would be to make FDIC's reserves available for this purpose. However, commingling the revenues, expenses, and reserves of the two funds would only provide about $14 billion in FDIC reserves (based on FDIC's estimate of reserves at the end of 1988) to help resolve the combined problems of FDIC and FSLIC. We believe that combining FSLIC and FDIC while leaving existing funding arrangements in place is not a realistic solution. To show the initial impact of combining the funds, we constructed a consolidated balance sheet for FDIC and FSLIC as of December 31, 1987. The results are shown in appendix VII.

As of December 31, 1987, the combined fund would have a reserve of less than $5 billion, or .17 percent of insured deposits.[1] Given the magnitude of the thrift industry's problem, the fund would be hopelessly weak. In addition, as explained more fully in appendix II, FDIC expects to suffer net losses in 1988. Thus, while a merger of existing fund financial resources could make additional funds available quickly to resolve thrift cases, it would be at the expense of a shortfall in funds needed for the banking industry. It would also run contrary to banks' general expectation that they had contributed money to FDIC for their own insurance needs.

Another option is to increase FDIC-insured bank premiums to help meet the funding shortfall. While we are not rendering a judgement on the merits of the option, we note that one advantage of such a contribution would be that it would tend to mitigate the negative competitive impact of attempting to raise money strictly from healthy thrifts.

If a financial contribution is sought from FDIC-insured banks, the case for merging the funds is strengthened due to the need to be sure that the money is well spent. However, merger is still not necessary. As we point out in chapter 6, controls that the federal government should put in place to assure that its interests are protected would provide the protection needed over expenditures of bank contributions.

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[1] Unaudited financial data for both FDIC and FSLIC for September 30, 1988, show that the combined fund would be technically insolvent.

Conclusions

By itself, merger of the deposit insurance funds would not address the problems associated with FSLIC's insolvency. Indeed, combining the FDIC and FSLIC funds to gain access to FDIC's reserves could weaken the entire deposit insurance system. FDIC's resources, which are needed to deal with the banking system's problems, would be quickly depleted, leaving the deposit insurance system worse off than it is now because the fund insuring bank deposits would also be insolvent.

If it provided the stimulus for carrying out the actions to resolve the FSLIC problem that we have discussed, a merger of the administrative aspects of the insurance funds could in that sense be helpful. But these actions can, for the most part, be accomplished without a merger through the creation of a new FSLIC that is independent and organized into good company and bad company funds that could draw on the personnel resources of FDIC or other federal agencies.

The principal reason why alternatives to full merger should be sought is that merging the deposit insurance funds has some significant drawbacks.

- Public confidence in the Nation's banking system could be adversely affected.
- At least initially, attention could be diverted from problems within the banking industry and the pressures for action or inaction that have been directed toward FSLIC in its handling of the problem could be inappropriately redirected to FDIC.
- Fundamental decisions on regulatory structure and the continued usefulness of a specialized housing industry lender could be avoided or delayed causing a long-term cross subsidization within the fund of thrifts by banks.
- If it were felt that fundamental regulatory structure changes had to accompany merger of the funds, a protracted debate could follow which would delay implementation of a program to deal with the thrift industry problem.

In our view, a full merger of the funds is technically possible, but we recommend against it at this time. Only when comparable risk management policies are in place, when the viable portion of the industry is as financially sound as the banking industry, and when decisions have been made about the appropriate regulatory structure within which both thrifts and banks can compete on an equal footing would it be more appropriate to consider whether to merge the funds.

Matter for Consideration by the Congress

As an alternative way to provide the independent point of view and additional personnel resources and expertise needed both to identify and resolve problem thrift cases and to provide effective deposit insurance for healthy thrifts, Congress should consider merging the administrative aspects of FDIC and FSLIC.

Agency Comments and Our Evaluation

FHLBB and NCUA commented explicitly on the issue of merging the fund. FHLBB concurred with the view that a simple merger of the insurance funds will not solve either the thrift or commercial bank problem. FHLBB said it was proposing a complete reform of the system, including some type of reinsurance mechanism, on the grounds that the current system has no provision to cover catastrophic losses. NCUA agreed that a merger of deposit insurance funds was not required or advisable.

Thrift Industry's Condition

Thrifts as Mortgage Lenders

Public policy has supported the role of thrifts as primary lenders in the housing finance market. As a result of the problems experienced by the industry during the Great Depression, FHLBS was created by the Federal Home Loan Bank Act of 1932 to channel funds to thrifts to facilitate mortgage financing and thus promote home ownership. In addition to FHLBB, which charters federal thrift institutions and is responsible for all federal regulation of thrifts, FHLBS includes 12 district banks that borrow in capital markets and then lend funds to member thrift institutions in the form of collateralized bank advances.

Interest-Rate Spread Problems of the Early 1980s

Thrifts have traditionally earned their profits through the funding of long-term mortgage assets with lower interest rate short-term deposits. Though mortgage assets continue to dominate thrifts' portfolios, as a percent of total assets, mortgages have declined from nearly 86 percent in 1977 to 70 percent in 1987. From 1966 until 1980, interest rates thrifts could pay on time and savings deposits were constrained by the Federal Reserve Board's Regulation Q. When market interest rates would rise above Regulation Q ceilings, thrifts would experience decreased deposit inflows and occasionally net deposit outflows.

Until the early 1980s, the problems associated with disintermediation were not serious enough to severely impair thrift performance. However, the rapid rise of interest rates that began in 1980 prompted large deposit outflows from thrifts.

These outflows forced thrifts to raise interest rates paid on deposits and to rely on market-rate FHLB advances which also increased thrifts' cost of funds dramatically. Because fixed-rate mortgages comprised about 80 percent of thrift assets in 1980, it was difficult for thrifts to increase earnings on a large portion of their assets when interest rates increased. Consequently, in 1982, the thrift industry's cost of funds was over 11 percent while the average return on mortgage holdings was under 11 percent. The net interest margin (NIM) of the industry declined quickly and industry return on assets (ROA) reached a low of -.97 percent in June 1982.

The thrift industry experienced losses of $8.8 billion in 1981 and 1982 combined. The result was a depletion of thrift industry capital and an alarming increase in thrift insolvencies.

Congressional and Regulatory Response to Thrift Industry Problems

The unprecedented deposit outflows experienced by thrifts in the early 1980s caused Congress to act swiftly to deregulate interest rates paid on deposits. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) provided for the phaseout of interest-rate ceilings on thrift and bank deposits. DIDMCA also allowed thrifts to diversify their asset portfolios into areas that were previously the domain of commercial banks. Further, in an effort to increase the interest rate sensitivity of thrift asset portfolios, FHLBB in 1981 authorized all federally chartered thrift institutions to make adjustable rate mortgages (ARM).

However, the net worth position of thrifts continued to deteriorate. In 1982, Congress passed the Garn-St Germain Depository Institutions Act. The act further expanded thrift asset powers in the areas of commercial and consumer lending. Although some institutions report large holdings of these assets, on average, thrifts have not taken advantage of these expanded powers. Commercial loans and consumer loans comprised only 1.88 and 4.41 percent of total thrift assets, respectively, at midyear 1987.

In the period following enactment of the Garn-St Germain Act, the thrift industry experienced extremely rapid growth. Assets in the industry increased about 40 percent between 1982 and 1984, a rate of growth much greater than the rate of growth of GNP or the rate of growth of commercial banking assets. This growth was financed in part with deposits over $100,000 and repurchase agreements. The current problems of the industry may stem, at least in part, from this period of rapid growth because institutions were able to use the insured deposits to finance what proved to be high-risk ventures.

Between January 1980 and December 1987, 331 FSLIC-insured institutions were closed.[1] In addition, many other insolvent thrifts were permitted to remain open. Only 21 operating FSLIC-insured institutions reported negative GAAP net worth as of June 1981. As of March 1988, this number had grown to 500 institutions.

The response of FHLBB to the deteriorating condition of the industry was one of showing forbearance to capital deficient thrifts. Forbearance involves delaying the closure of thrifts by either augmenting the value of capital they report for regulatory purposes (based on Regulatory Accounting Principles [RAP]) or lowering the minimum capital requirements thrifts must meet in order to be permitted to continue to operate.

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[1] Closed institutions were liquidated or merged.

Forbearance through means of capital augmentation was first undertaken in 1981. At that time, thrifts were permitted to begin to defer over time any losses incurred on the sale of selected assets and to count income capital certificates (ICC) in RAP net worth.

In 1982, certificates similar to ICCs, known as net worth certificates (NWC), were authorized by the Garn-St Germain Act. Both NWCs and ICCs served to increase the RAP net worth of qualifying institutions to the regulatory minimum and thereby avoid a FSLIC takeover.

Both the RAP and GAAP net worth of the industry continued to decline from 1980 until December 1984 but, due to the use of these capital augmentation techniques, RAP net worth declined more slowly than GAAP. The other form of forbearance, that of lowering the capital requirements thrifts must meet, was first instituted in 1980 when the minimum RAP net worth requirement was lowered from 5 to 4 percent of assets. It was again lowered, to 3 percent, in 1982. In addition, FHLBB said in February 1987 that it was unlikely to take administrative action to enforce minimum capital requirements.

During the period of declining net worth and of a growing number of insolvent thrifts, FSLIC found itself increasingly unable to deal with problem cases. After a record 252 resolutions in 1982, the number of thrift closures dropped to 102 in 1983 and to 41 in 1984. During the same 3 years, the number of GAAP-insolvent institutions operating increased from 222 in 1982, to 281 in 1983, and then to 434 in 1984. Although FSLIC had reserves averaging $5.7 billion from 1982 through 1985, FHLBB estimated in 1985 that it would take $15.8 billion to close all GAAP-insolvent institutions.

Partly as a result of the deteriorating condition of the insurance fund, FHLBB in 1985 began to place institutions in the Management Consignment Program (MCP). The goal of MCP is to minimize the losses of FSLIC by taking control of those insolvent institutions that pose the greatest threat of future losses. When an institution is placed in the program, the board of directors and the management of the institution are replaced with new managers, usually from another thrift, who are chosen by FSLIC. In September 1987, GAO reported on the condition of the 45 institutions in MCP as of year-end 1986.[2] It was shown that these institutions still incurred great losses after they entered the program, reporting $2 billion of losses between the end of the quarter during which they entered MCP and year-end 1986. Their aggregate GAAP net worth declined from $-0.8 billion to $-3.49 billion over the same period. It is possible that the losses of these institutions could have been just as large or larger than they actually were had they not been put into MCP.

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[2] Thrift Industry: The Management Consignment Program (GAO/GGD-87-115BR, September 1987).

In May 1987, we reported on the ability of institutions that were shown forbearance to return to health.[3] In that report, the financial condition of the 222 thrifts that were insolvent at year-end 1982 were tracked through September 1986 to determine if, having been allowed to continue to operate, they attained a positive net worth position. Of the 222 institutions, 77 were liquidated, merged, or reorganized during the period and 145 remained open on September 30, 1986. Of the 145 operating thrifts, 80 remained insolvent while 65 had attained a positive level of GAAP capital. Of the 65 which had regained solvency, only 25, or 11 percent, of the original 222 had fully recovered.[4] It should be noted however, that the institutions in this sample were initially insolvent due principally to interest rate rather then asset quality problems.

We also examined the change in the condition of problem institutions in the thrift industry between the end of 1986 and 1987. These problem institutions were ones that were either GAAP insolvent as of December 31, 1986, or had lost money in 1986 and had less than 3 percent net worth. During 1987, 47 institutions with assets of about $11 billion were liquidated or merged with FSLIC assistance. By December 31, 1987, 59 institutions had recovered sufficiently to be either no longer insolvent or not losing money in 1987. This definition of recovery may not, however, provide a true measure of the economic condition of the institutions because it does not reflect an analysis of either the quality of the capital or of the net income of the institutions. Furthermore, during this period, an additional 197 institutions with assets of $126.7 billion (13 percent of the assets of those that were not defined as problem thrifts in 1986) entered the problem thrift category in 1987. (See table I.1.)

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[3] Thrift Industry: Forbearance for Troubled Institutions 1982-1986 (GAO/GGD-87-78BR, May 1987).

[4] Full recovery was defined as having a GAAP net worth to assets ratio of at least 3 percent and being profitable during the first 3 quarters of 1986.

Table I.1: Change in Condition of Thrift Industry Institutions, 1986 to 1987[a]

Dollars in billions

Category of institutions	Total assets in 1986	Number
Weak in both 1986 and 1987	$137.3	458
Weak in 1986 to not weak in 1987	16.7	59
Not weak in 1986 to weak in 1987	126.7	197
Not weak in both 1986 and 1987	837.3	2,323
Existed in 1986 and did not exist in 1987[b]	47.3	183
Total	**$1,165.3**	**3,220**

[a] Weak is defined as (1) was insolvent or (2) 0-3 percent net worth and lost money in 1987.

[b] Includes institutions that failed, merged, or were acquired by another institution. Not all of these institutions represent problem cases

Asset Quality Problems and the Current Condition of the Thrift Industry

As interest rates began declining in 1982, thrifts' interest-rate spread problems began to subside and overall profitability of the industry began to rise. Although nearly 7 percent of the industry remained insolvent, it appeared for a while that the industry was recovering. However, in early 1986, average ROA for the industry again began to decline. Since the fourth quarter of 1986, the industry as a whole has lost money in every quarter (through June 1988), except for the first quarter of 1987.

It is important to note that although a significant portion of the industry is insolvent and deteriorating, many thrift institutions are adequately capitalized. At year-end 1987, there were 3,147 FSLIC-insured institutions. Of these, 505 were insolvent on a GAAP basis, 435 had a GAAP capital to assets ratio of at least zero but less than 3 percent, 1,014 had a capital ratio between 3 and 6 percent, while the remaining 1,193 were adequately capitalized with a capital ratio of at least 6 percent. (See table I.2.) Nearly two-thirds of all thrifts made net profits during 1987. However, the $13.4 billion losses of the unprofitable thrifts outweighed the profits of the profitable thrifts which totaled $6.6 billion, resulting in a net loss of $6.8 billion for the industry in 1987.

Table I.2: Selected Financial Information for Savings and Loan Institutions as of December 31, 1987

Dollars in billions

GAAP net worth	Number of S&Ls	Percent of total	Total assets	Total deposits	GAAP net worth
Less than -12%	182	5.8%	$43.2	$49.3	(14.3)
From -12 to -9	33	1.0	5.5	4.7	(0.6)
From -9 to -6	61	1.9	23.0	19.6	(1.7)
From -6 to -3	75	2.4	17.5	14.8	(0.7)
From -3 to 0	154	4.9	51.1	40.4	(0.7)
From 0 to 3	435	13.8	255.2	175.7	4.0
From 3 to 6	1,014	32.2	555.9	398.7	25.0
From 6 to 9	743	23.6	231.0	177.1	15.9
From 9 to 12	290	9.2	38.6	31.6	3.9
More than 12	160	5.1	30.7	20.9	6.0
Total	3,147	100.0	$1,251.6	$932.7	$36.8

Note: Numbers may not add to total due to rounding.

The 577 problem thrifts[5] that we identified in chapter 2 (as of December 31, 1987) have a geographic concentration that suggests an underlying regional component to the problem.[6]

Nearly 50 percent are concentrated in the Dallas and Topeka FHLB districts. The Dallas district contains 205, or 36 percent, of these thrifts, and an additional 62, or 11 percent, are located in the Topeka district. Texas, Louisiana, and Oklahoma, three of the nine states that these two districts incorporate, have suffered particularly heavy losses due to the economic downturn in the agriculture, energy, and real estate sectors of the economy. The problem institutions located in these two districts account for 75 percent of the net losses experienced by problem thrifts during 1987 and account for 48 percent of the assets of problem thrifts.[7]

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[5] We define a problem thrift as one that is either insolvent at year end 1987 or has a GAAP net worth as a percent of assets between 0 and 3 percent and has lost money throughout both 1986 and 1987. See tables 2.1 and 2.4.

[6] See page 2 of Danny Wall's testimony on May 26, 1988 before the Senate Committee on Banking, Housing and Urban Affairs. Also see pp. 21-22 of his July 7, 1988 testimony before the House Committee on Banking, Finance and Urban Affairs.

[7] The asset size of problem thrifts is also an important factor because insurance funds typically have a harder time resolving the problems of larger institutions. Of the $175.2 billion of the total assets in the 577 problem thrifts, 43 percent of the total assets are in 35 institutions with assets greater than $1 billion and 14 of these institutions are located in the Dallas FHLBB district. The average size of the 150 commercial banks closed by FDIC in 1987 was approximately $40 million.

The greatest problem insolvent institutions currently face is poor asset quality. That is, these thrifts are currently holding assets that are not producing income or are worth less today than what they were when they were first acquired. Over the last decade, thrifts have expanded their asset portfolios into areas beyond the single family mortgage loans traditionally originated and held by thrifts. Mortgages on one to four family dwelling units comprised 67.8 percent of thrift assets as of December 1980. By June 1987, this ratio had declined to 37.1 percent.[8] Thrifts have, however, acquired a significant volume of mortgage-backed securities. Nonetheless, as already noted, thrift mortgage assets as a percent of total thrift assets has declined. But over the same period, the percent of thrifts' assets in acquisition and development loans as well as in nonmortgage assets, such as commercial and consumer loans, direct investments, liquid assets, intangible assets, repossessed assets, and investment securities, have increased.

There has been considerable controversy surrounding thrift investment in some of these assets, especially direct investments. Believing that direct investments increase the cost to FSLIC of disposing of failed thrifts' assets, FHLBB passed a rule in March 1985 that limited thrift holdings of direct investments to the greater of 10 percent of an institution's assets or twice its regulatory net worth. In March 1987, the rule was revised and allowable direct investments holdings were more closely tied to thrift net worth levels.

Some thrifts suffering from spread problems in the early 1980s were successful in working out their problems in the lower interest rate environment of 1982 to 1986. However, if a policy of forbearance were now practiced in the hopes of encountering declining interest rates, it is unlikely that this would benefit thrifts whose current problem is bad assets. Further, it is unlikely that the problem assets of many of these thrifts will increase in value though they may deteriorate further.

Some studies have shown that failed institutions with asset quality problems stemming from direct investments are more expensive for FSLIC to resolve than failed thrifts which became troubled mainly due to interest rate spread problems. Estimates provided by FSLIC on its cost to resolve thrifts that required FSLIC assistance increased from an average of 7.3 and 4.2 percent of thrift assets resolved in 1981 and 1982, respectively, to 41.1 percent for thrifts resolved in 1987. In other words, FSLIC lost an average of 41 cents on each dollar of assets of thrifts resolved in 1987.

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[8] Though thrifts remain the dominant originators of long-term residential housing mortgages, their market share of originators has dropped from nearly 55 percent in 1976 to 47 percent in 1987.

In addition, the losses and resulting depletion of capital which occurred in the early 1980s may have produced an incentive for the management of capital-deficient thrifts to undertake greater risk to recoup their losses whether it be through reduced underwriting standards on loans, investing in areas in which they have little or no expertise, or investing in assets which are riskier in terms of the probability of loss but with a potentially large return should the venture be successful. Finally, other thrift analysts have pointed to relaxed examination and supervisory standards by the FHLBS as one of the factors contributing to the thrift industry's problems.

Whatever the cause of the industry's current condition, there is little disagreement that the existing thrift problems will be expensive to resolve. In addition, the continuing losses of the insolvent and capital deficient thrifts pose an ever-increasing threat to the FSLIC fund.

Appendix II

Condition of Commercial Banks and Saving Banks and the Outlook for FDIC

Commercial Bank Condition

Since the early 1980s, the financial condition and profitability of the commercial banking industry has been declining. Commonly cited reasons for this deterioration include interest rate volatility, inflation and its aftermath, increased competition both internationally and within the United States, and problems in the energy and agriculture sectors of the economy and their resulting impact on the real estate sector in certain regions of the country. In addition, the debt servicing problems of certain less developed countries have adversely affected bank earnings. The problems of the banking industry have been manifested in record numbers of bank failures over the last several years and a substantial increase in FDIC costs of those failures. (See table II.1.)

Table II.1: Condition of the Commercial Banking Industry (Ratios in Percentages)

Dollars in billions

Year	Return-on-assets[a]	Capital-over-assets[b]	Allowance-over-assets[c]	Total assets[d]	Number of commercial banks[e]	FDIC-assisted or failed banks
1980	0.75%	5.79%	0.54%	$1,856	14,435	11
1981	0.73	5.83	0.56	2,029	14,414	7
1982	0.68	5.87	0.61	2,194	14,452	34
1983	0.64	5.99	0.66	2,342	14,465	45
1984	0.63	6.15	0.74	2,509	14,482	79
1985	0.67	6.20	0.85	2,731	14,405	118
1986	0.60	6.21	0.97	2,941	14,198	144
1987	0.12	6.04	1.64	3,001	13,700	201

[a] Return-on-assets = net income divided by year-end assets.

[b] Capital-over-assets = year-end GAAP capital divided by year-end assets.

[c] Allowance-over-assets = year-end reserves for bad loans and leases over year-end assets.

[d] Total assets at year-end in FDIC-insured commercial banks.

[e] Number of commercial banks insured by FDIC.

Condition of FDIC-Insured Savings Banks

Savings banks insured by FDIC operate similarly to thrifts that are insured by FSLIC. In 1987, they held $217 billion in assets compared to over $3,000 billion in commercial bank assets. Their main source of funding, time deposits, is used primarily to make mortgage loans. Currently, most of these savings banks are located in the Northeast and the bulk of them are in Massachusetts, New York, and Connecticut.

As with thrifts and commercial banks, savings banks faced losses in the early 1980s due to mismatches between short-term deposit rates and long-term mortgage rates. Since 1985, however, savings banks have been performing well in contrast to many FSLIC-insured thrifts. (See table II.2.)

Table II.2: Condition of the FDIC-Insured Savings Bank Industry (Ratios in Percentages)

Dollars in billions

Year	Return-on-assets[a]	Capital-over-assets[b]	Allowance-over-assets[c]	Total assets[d]	Number of savings banks[e]
1982	−0.80%	5.36%	0.11%	$155	315
1983	−0.10	4.34	0.11	171	294
1984	0.07	4.66	0.15	179	291
1985	0.71	5.67	0.19	205	392
1986	1.00	7.41	0.24	237	472
1987	0.74	7.84	0.31	217	462

[a] Return-on-assets = net income divided by year-end assets

[b] Capital-over-assets = year end GAAP capital divided by year-end assets

[c] Allowance-over-assets = year-end reserves for bad loans and leases over year-end assets

[d] Total assets at year-end in FDIC-insured savings banks

[e] Number of savings banks insured by FDIC

FDIC Reserves

FDIC's statute does not set forth a level of reserves that FDIC must maintain at all times. Statutory language does, however, set a minimum standard for reserves of 1.10 percent of insured deposits.

FDIC's reserve requirements are as follows: when reserves are less than 1.10 percent of estimated insured deposits, the Board of Directors must increase the portion of assessment income (up to, but not to exceed 50 percent) placed in reserves to maintain a reserve level no less than 1.10 percent. Once reserves exceed 1.25 percent of estimated insured deposits, the Board may reduce the portion of assessments reserved but not below the point where reserves would become less than 1.25 percent of estimated insured deposits. If the ratio of reserves to estimated insured deposits exceeds 1.40 percent, the Board must reduce the portion of assessment income reserved to the point where reserves will not exceed 1.40 percent of estimated insured deposits. The provisions for FDIC reserves are similar to the statutory provisions concerning FSLIC and NCUSIF reserves.[1]

FDIC reserves increased from $11 billion at the end of 1980 to almost $18 billion at the end of 1985 and remained at about that level during 1986 and 1987. However, the ratio of insurance fund reserves to insured deposits declined from 1.24 percent at the end of 1981 to 1.10 percent at the end of 1987, the lowest ratio in FDIC's history.

In the fall of 1988, FDIC anticipated its reserves would fall by about $3 billion in 1988, with a level of reserves at the end of the year of approximately $15 billion. FDIC officials indicate that the level of reserves would then increase by about $500 million in 1989. After 1989, FDIC anticipated that the number of bank failures will become less of a problem.

Growth in Weak or Insolvent Commercial Banks

In December 1987, there were 66 insolvent banks which held a combined total of $8.8 billion in assets, more than triple that of the year before. Most of the open insolvent banks were located in the Southwest. There has also been a substantial increase in weak institutions in which capital is more than or equal to 0 percent of assets but less than 3 percent. In 1987 there were 250 institutions in this category with assets of about $115 billion. Although preliminary data show that the number of insolvent and weak institutions declined somewhat in 1988, 3.72 percent of commercial bank assets on June 30, 1988, were in insolvent or weak institutions. (See table II.3.)

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[1] FSLIC's reserves have two components, primary and secondary. The primary reserves are from the regular assessments and the secondary from the special assessment established by Congress in 1962. Congress scheduled a payback of the secondary reserve to be put into effect when the total reserves exceeded 1.25 percent of total deposits. Congress suspended the payback because reserves fell below that minimum.

The Federal Credit Union Act amendments to the Omnibus Deficit Reduction Act of 1984 (P.L. 98-369) required insured credit unions to deposit, beginning in January 1985, an amount equal to 1 percent of their insured shares as of December 31, 1984. The law authorized NCUA to determine a normal operating level for fund reserves, which NCUA has set at 1.3 percent of insured shares—the maximum level prescribed in the act. The NCUSIF recapitalization is explained in appendix VI.

Table II.3: Growth in Insolvent and Weak Commercial Banks Insured by FDIC

Dollars in billions

Year	Number of insolvent[a] banks	Assets in insolvent banks	Number of weak[b] banks	Assets in weak banks	Number of insolvent and weak banks	Combined assets in insolvent and weak banks	Ratio of combined assets to total industry assets
1980	1	$0.017	14	$1.669	15	$1.686	0.09%
1981	2	0.037	21	4.054	23	4.091	0.20
1982	5	0.179	43	4.235	48	4.414	0.20
1983	14	3.249	74	5.445	88	8.694	0.37
1984	8	0.25	68	7.098	76	7.348	0.29
1985	25	1.379	110	8.432	135	9.811	0.36
1986	58	2.588	203	19.235	261	21.823	0.74
1987	66	8.772	250	114.728	316	123.500	4.12
1988[d]	80	25.129	231	92.864	311	117.993	3.86

Source: FDIC's consolidated reports of condition and income

[a] Information is as of December 31 for each year except 1988.

[b] An insolvent bank has negative GAAP capital.

[c] A weak bank has a GAAP capital to asset ratio between 0 and 3 percent.

[d] In its comment letter, FDIC said there were 90 insolvent banks as of mid-year 1988. FDIC's figure is higher than ours because FDIC has been able to update its data base for banks that completed their June 30 reports after FDIC provided us the computerized data. FDIC also noted in its comment letter that 70 of the 90 institutions were either closed or merged out of existence in the second half of 1988, gained solvency during the third quarter, or have assistance proposals currently pending.

Our Assessment of FDIC's Resources

The existence of 66 GAAP insolvent and 250 low net worth banks with combined assets of $123.5 billion at year-end 1987 make it particularly difficult to assess the extent of the potential demand on FDIC's resources over the next 10 years. Another problem associated with projecting future losses for FDIC is that, as discussed previously in the report, the information contained in call reports may not provide a reliable picture of the condition of institutions. For example, in a report filed with the Federal Reserve by First RepublicBank Corporation 3 months before First RepublicBank first received FDIC assistance, the Corporation's balance sheet showed primary capital for regulatory purposes of about 7.6 percent of assets. Shortly thereafter, FDIC estimated initial outlays of $4 billion to arrange the acquisition of First RepublicBank by NCNB National Bank. The net cost to FDIC has not yet been determined but it is expected to be between $2 billion and $3 billion.

FDIC has not prepared an extended forecast for the period through 1998 that corresponds to that provided by FSLIC which we discussed in chapter 2. We have therefore concentrated on the outlook for FDIC over the next several years. Although we do not know what level of loss FDIC will experience, we believe FDIC will have difficulty in restoring its reserves to a level of 1.1 percent of insured deposits by 1992.

If FDIC's estimates about insurance losses for 1988 and 1989 that were mentioned above prove to be accurate, the reserve at the end of 1989 would be about $15.5 billion. If insured deposits in FDIC-insured institutions were to increase at a rate of about 7 percent per year—the same assumption FSLIC has used for its deposits—reserves at the end of 1989 would be .81 percent of insured deposits. This percentage is significantly below the 1.1 percent standard.

We have no basis for estimating FDIC's insurance losses beyond 1989. We have, however, considered the implications of trying to restore the FDIC reserve back to 1.1 percent of insured deposits by 1992, assuming that the level of reserves at the end of 1989 is the $15.5 billion anticipated by FDIC.

If FDIC deposits increase at about 7 percent per year, insured deposits in FDIC-insured institutions will be an estimated $2.3 trillion by 1992. The level of reserves needed to make a 1.1 percent reserves standard in that year would be $25.8 billion—$10.3 billion more than the $15.5 billion level FDIC officials anticipate for 1989. To obtain $10.3 billion for reserves, FDIC would have to devote virtually all of the premium and interest income that would be available to it in 1990, 1991, and 1992 to building up reserves. (See table II.4.)

Under the assumption set forth in the preceding paragraph, if FDIC is to achieve the 1.1 percent reserve level by 1992, the amount of money available to pay insurance losses in the years 1990, 1991, and 1992 would have to be less than the $.6 billion shown in table II.4. The reason for this is that insurance losses would reduce interest earnings on fund reserves. Such a low level of insurance losses in the 1990 to 1992 period seems highly unrealistic in view of the number of inadequately capitalized banks, recent insurance losses, and uncertainties that exist in the economy. For the 5 years 1983 to 1987, insurance expenses on a deposit base smaller than that which will exist in 1990 averaged $1.9 billion per year.

Table II.4: Analysis of Implications of Restoring FDIC Reserves to a Standard of 1.1 Percent of Insured Deposits by 1992, Assuming No Insurance Losses in 1990, 1991, and 1992

Dollars in billions	
Funds available	
Estimated premium and other income in 1990, 1991, and 1992, except income on investments	$7.0
Estimated income on investments in 1990, 1991, and 1992 assuming no insurance losses in that period[a]	4.7
Total funds available	**11.7**
Uses of Funds	
Estimated administrative and other miscellaneous expenses 1990, 1991, and 1992	.8
Additions to reserves	10.3
Total use of funds	**11.1**
Funds available in excess of those needed to restore reserves to a level of 1.1 percent of insured deposits	0.6

Note: The table assumes: (1) the level of FDIC reserves in 1989 is $15.5 billion (.81 of insured deposits); (2) deposits and insured deposits increase from 1987 through 1992 at a rate of 7.2 percent per year; and (3) the level of reserves needed in 1992 to achieve a standard of 1.1 percent of deposits is $25.8 billion.

[a] Insurance losses would reduce the interest income available because interest income would be lost on funds paid out in insurance losses.

Why Depository Institutions Have Incentives to Impose Risks on the Funds

A fundamental source of risk for deposit insurance agencies is moral hazard—the incentive for an insured institution to impose risks on the insurance fund. It arises because an insured party has less incentive to curtail risky behavior that can generate losses if the losses are covered, at least in part, by the insurer. Typically, moral hazard problems in private insurance arrangements are handled through deductibles and through constraints on the activities of the insured. In the case of deposit insurance, stockholder's equity may be viewed as the deductible, and federal and state supervision and regulation to promote safe and sound operations represent the analogous constraints on behavior.

The moral hazard problem associated with deposit insurance is particularly acute in the case of a near-insolvent or insolvent institution because such a firm has little or no capital of its own at risk. Moreover, managers of such an institution know that they will be removed if the chartering agency closes the institution. In such cases, the management and owners have the incentive to "bet the bank" by investing in assets with potentially large but highly variable rates of return. If the gamble pays off, the bank or thrift may return to solvency and management positions will be secure. If the gamble fails, most or all of the losses resulting from the gamble accrue to the deposit insurance fund.

Any insurance system should be structured to minimize the risk posed to the insurer by moral hazard. The deposit insurance funds attempt to achieve this through capital requirements and through supervision and regulation. However, a combination of factors, discussed below, have made the current approach inadequate. As a result, the deposit insurance funds, particularly the FSLIC fund, face current and future losses due to moral hazard.

Inadequate Funding and Performance

The moral hazard problem encountered by a deposit insurance fund is aggravated by inadequate funding and capital forbearance. An insurance fund with inadequate funding, such as FSLIC, cannot resolve its current caseload in a timely fashion, thereby leaving institutions open with little or no capital. When left open, these institutions have the greatest incentive to gamble since it is the insurance fund's money rather than the owners' depleted capital that is most at risk.

Flat Rate Premiums

Currently, risk is priced implicitly by increased supervision and oversight of problem institutions. However, this implicit cost for risk-bearing occurs with a lag and is assessed after the fact. The moral hazard problem with flat-rate premiums then, is that banks do not bear the full social cost of their risk-taking. In principle, the solution to this problem is to set the premiums charged commensurate with the anticipated risk of loss that the institution poses to the insurer.[1]

De Facto Coverage of All Deposits

When a depository institution fails, only deposit accounts up to the insurance limit are guaranteed. In practice however, full coverage has usually been extended to all depositors and creditors, particularly of larger banks. Such de facto 100 percent coverage diminishes the incentive of uninsured depositors and creditors to monitor institutions' risk-taking. Therefore, market-induced incentives to curtail risk-taking have been dampened.

Lack of Market-Value Data

Minimizing moral hazard requires closing institutions prior to, or at the point of economic insolvency, in order for the deductible feature of deposit insurance to work. Lack of market-value data makes this particularly difficult to accomplish. Without sufficient information, regulators may inadvertently leave open an institution without any capital. These institutions pose the greatest moral hazard risk to the insurance funds.

Inadequate Supervisory and Examination Resources

As noted above, regulation and supervision are the principal tools used by the deposit insurance agencies and other federal and state agencies to control moral hazard. Many observers, including ourselves, have commented on FHLBB's as well as other bank regulators' lack of resources necessary to carry out required oversight. This situation worsens the moral hazard problem.

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[1] If the premium is set according to the risk of loss an institution poses to its deposit insurer, the institution internalizes the cost of its risk-bearing. In practice, however, risk-based pricing can be difficult to implement. See the discussion in appendix IV. The objectives of protecting the fund from risk through risk-based premiums can also be accomplished by risk-based capital requirements for insured institutions. This is also discussed in appendix IV.

Deposit Insurance Reform Proposals

In the last few years a number of proposals for reform of the deposit insurance system have been advocated by representatives of the industry, regulatory, and academic communities. These reforms have been designed to solve a number of problems with the existing deposit insurance system. The following are some of the problems cited.

- The methods typically employed in disposing of a failed institution limit the market discipline imposed by uninsured depositors and creditors because their probability of loss is sharply curtailed. As a result, both insured and uninsured deposits can always be obtained by offering higher rates on deposits.
- Deposit insurance is underpriced.
- Risk underwriting by the deposit insurance system is extended because depository institutions or the holding companies that own them are diversifying their activities into more types of financial products.[1]
- Large institutions that are considered too big to fail receive favored treatment.

A discussion of some of the reform proposals that have been made follows.

Modified Payouts, Co-Insurance, Reduced Deposit Insurance Limits, and Use of Subordinated Debt to Meet Higher Capital Requirements

To deal with lack of market discipline on insured institutions' risky activities, several proposals have been advanced to require that parties other than the deposit insurance fund bear losses if institutions fail. There are several proposals to accomplish this. For example, deposit insurance coverage could be scaled back to some lower amount such as $40,000; a deductible of, say, 10 percent of deposits over $20,000 could be imposed; or insurance could cover only principal at the beginning of a stated period and not accumulated interest. By such measures, depositors could no longer with impunity send their money to the bank or thrift that advertises the highest rates. A problem with these approaches, however, is that depositors may be unable to determine the true condition of the insured institution. This problem is more likely to be experienced by depositors than by investors. Therefore, requiring institutions to make increasing use of subordinated debt, which in most instances would be supplied by knowledgeable investors, represents a particularly attractive way of increasing market discipline.

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[1] See footnote 10 of chapter 5, p. 74.

The credibility of plans for cutting back insurance coverage or making use of subordinated debt depends upon the certainty with which uninsured depositors or bond holders will actually lose money if institutions fail. To strengthen this credibility, as well as to alleviate equity issues associated with the "too-big-to-fail" problem, proposals have been made to eliminate de facto insurance for uninsured depositors and general creditors by requiring the deposit insurance funds to use what is termed a modified payout if institutions are merged rather than liquidated. Under this approach, if an institution fails, FDIC or FSLIC would immediately pay all insured depositors in full. The agency would, however, advance to uninsured depositors and general creditors the present value of their estimated share of the value of the assets, an amount that could easily be less than 50 cents on the dollar.

This proposal, like the ones for reduced insurance coverage, suffers from the problem of how uninsured depositors are to know about the condition of their bank. Concerns have also been expressed that these sorts of proposals could destabilize the banking system because at the first hint of problems (which may not actually exist), uninsured depositors may run from the bank. This concern is particularly important because the largest banks in the country fund their activities with large amounts of uninsured deposits. Runs on large banks could lead to runs on other banks. Those suggesting the modified payout and the other proposals that would increase depositor discipline counter that with enlightened monetary policy, it is unlikely that the failure of one bank would lead to a disastrous contraction of the U.S. banking system.

Risk-Based Insurance Premiums and Capital Requirements

Under the current system, each insurer charges its institutions a flat premium rate per dollar of deposits. As a result, there is no explicit price put on the riskiness of individual institutions. This encourages risk taking and creates inequities because prudently managed institutions subsidize those posing a greater risk to the insurance fund. Additionally, banks and thrifts each face uniform capital requirements, regardless of the risk inherent in their portfolios. FHLBB is phasing in new capital standards that contain adjustments for interest rate risk exposure and the bank regulators are completing new capital guidelines that are based on credit risk.

Currently, risk is priced implicitly by increased supervision and oversight of problem institutions. However, this implicit cost for risk bearing occurs with a lag and is assessed after the outcome of risk taking has occurred. In principle, the solution to this problem is to set the premiums charged so that they reflect the expected loss to the insurer inherent in the asset portfolio selected; that is, when the risk is undertaken, not when the outcome is learned.[2]

There are two ways to price the risk to the deposit insurer: adjusting the insurance premium charged or adjusting the capitalization level required based on the prospective riskiness of each institution's portfolio.

Risk-Based Premiums

A risk-based premium adjusts the premium charged each institution to reflect the expected loss to the insurer from the institution's risk taking. Pricing according to risk has been advocated as a means of forcing an institution to realize a greater proportion of the cost of its risk taking, thereby reducing the moral hazard problem. This approach has received considerable attention and has generated a number of specific reform proposals.[3]

The first problem in setting a risk-based premium is determining what measure(s) to use in judging risk. Three general approaches have been discussed. The first estimates risk from either the portfolio mix and/or capital base of an institution. The second utilizes a put-option model to calculate the expected value of the institution. The third uses call report data on the balance sheet and earnings, possibly in conjunction with examiner CAMEL ratings.[4,5] Premiums may be set on an institution-by-institution basis or institutions may be grouped into risk groups with each group charged the same premium rate. While the former is more desirable theoretically, the latter is more easily implemented.

The advantages to risk-based premiums include reducing the subsidy provided to relatively risky institutions at the expense of more prudently managed ones. Moreover, proper pricing of risks forces banks and thrifts to recognize the true cost of their risk taking, thereby altering the incentive to undertake such activity. Properly priced, premiums also should produce income sufficient to offset expected future losses. However, a number of problems exist in implementing such a proposal.

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[2] By setting the premium according to the expected risk of loss an institution poses to its deposit insurer, the institution is forced to internalize the cost of its risk bearing.

[3] See Arthur J. Murton, "A Survey of the Issues and the Literature Concerning Risk-Related Deposit Insurance," in Federal Deposit Insurance Corporation Banking and Economic Review, September/October 1986, pp. 11-20, for an overview of this literature. See Eric Hirschorn, "Developing a Proposal for Risk-Related Deposit Insurance," pp. 3-10, in the same issue for a discussion of the FDIC proposal for risk-based pricing.

[4] CAMEL ratings are judgments made by examiners on a 1-5 point scale. Ratings are given for each of five areas plus an overall rating. The five areas examined are capital adequacy, asset quality, management, earnings, and liquidity.

[5] The FDIC proposal utilizes this approach to measuring risk, using call report data and CAMEL ratings. See "Developing a Proposal for Risk-Related Deposit Insurance."

- First, it is important that risk be measured at the time a risk is undertaken, not when the outcome is known. Furthermore, assessing increased premiums after an institution has begun to show losses resulting from risk taking may be counterproductive. The point of risk-based pricing is to have each institution pay a premium commensurate with the expected loss its behavior implies for the insurance fund. Ideally, risk-based premiums should be designed to deter excessive risk taking, not punish it.
- Second, at the time the risk is undertaken, measures of risk are not directly available and proxy measures such as CAMEL ratings may be available only with a lag. Further, risk is not a static condition but rather may continually change. The data problems are most severe for the put-option model. It is also argued that use of CAMEL ratings may adversely affect the process of conducting bank exams because the use made of the rating may influence the objectivity of the examination.
- Third, the differences in premiums charged must be significantly large to reflect differences in risk. In practice, especially given the monopoly nature of federal deposit insurance, a political problem may arise if very large bills are sent to various insured institutions by a federal agency.

Risk-Based Capital Enhanced Capital Standards

Rather than pricing risk directly through the premium charged, capital requirements may be adjusted according to the level of risk undertaken since capital serves as the cushion against losses. By increasing capital requirements as the possibility of loss increases, the protection of the insurance fund is maintained. Alternatively, uniform capital standards can be maintained but the required levels increased. Further, capital reporting could be required on a market value basis or the elements of capital could be modified. For example, loan loss allowances could be reduced as a component of capital or unlimited amounts of subordinated debt could be included.[6]

Risk-based capital proposals have some advantages over risk-based premiums. First, potentially large amounts of money do not have to be paid to the insurance fund as would be the case with a risk-based premium. In addition, risk-based capital proposals introduce an element of actual market pricing because capital (including subordinated debt) must be raised in competitive capital markets. In these markets, institutions perceived by investors to be more risky will have to pay more to obtain a given amount of capital.

Risk-based capital also, however, has some of the same problems as risk-based premiums. Prospective risk is hard to measure and there are questions as to whether the political environment within which deposit insurance is administered will permit capital requirements for individual institutions to be varied enough to really account for actual differences in riskiness.

Risk-based capital also has several drawbacks compared to risk-based premiums. Insurance premiums are likely to be able to be adjusted much more frequently than capital requirements, and it may take more time for an institution to come into compliance with a higher capital requirement. Also, capital requirements are generally set by the primary supervisory agency, whereas the deposit insurance funds could set risk-based insurance premiums.

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[6] The FDIC, the OCC, and the Federal Reserve Board have developed a joint risk-based capital proposal developed in conjunction with representatives from the central banks and supervisory agencies from 12 major industrial countries. (The countries include the United States, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, the United Kingdom, Switzerland, and Luxembourg.) Each of the U.S. agencies issued its own specific set of proposed guidelines, but the framework for each is the same.

This framework consists of two types of capital, core and supplemental, which summed must be at least 8 percent of risk-weighted assets by 1992. Core capital, which must be at least 4 percent of risk-weighted assets, consists primarily of common stock and retained earnings. Supplemental capital could include loan loss reserves, preferred stock, and subordinated debt, subject to limitations. Supplemental capital counted toward the total capital requirement cannot exceed core capital. Asset categories and off-balance-sheet items are assigned weights from zero to one based principally on their credit risk.

A major objective of this proposal is to include off-balance-sheet risk in the capital standard. This and similar proposals reduce the risk to the insurer by establishing a capital cushion that increases with risk, including that posed by off-balance-sheet items. Assigning different weights to asset categories recognizes differences in credit risk across asset types and reduces disincentives to holding liquid, low-risk assets.

There are several additional criticisms of the risk-based capital proposals.

- First, capital is measured using a historical basis rather than at market value.
- Second, the weights assigned are ad hoc and do not necessarily reflect risk differences across categories, and they do not allow for possibly substantial risk differences across assets within a category.
- Third, they do not account adequately for interest-rate risk or for the risk-reducing benefits of asset diversification.
- Fourth, proposals that would adjust capital according to risk in the United States by more than that done in other countries could weaken the competitiveness of U.S. banks.

Forcing Insured Institutions Themselves to Absorb Risks by a Market Value Closure Rule, Collateralizing Deposits, or Narrow Banking

Risk-based premiums and capital proposals attempt to prospectively put a price on risk taking. As indicated, there are a number of significant limitations to actually achieving this result. However, another set of proposals designed to limit the insurer's risk may have the same intended effect of making institutions bear the cost of risk taking without the problems associated with federal officials having to make specific decisions about insurance premiums or capital levels. These include

- closure at zero market value,
- collateralizing deposits, and
- significantly limiting the uses made of insured deposits.

Market Value Closure Rule

Currently, FDIC and FSLIC each use their own definition of regulatory capital in setting capital standards, granting capital forbearance, and making closure decisions. In recent years, these measures may have drastically overstated the true economic value of depository institutions, particularly undercapitalized and insolvent institutions. If insured institutions were closed when their economic value was zero, the deposit insurance agencies could liquidate them and suffer little or no loss. In addition, if this were to occur, the deposit insurer would not have to maintain a large amount of reserves to underwrite risks taken by the insurance fund.

Critics argue that determining the economic value of institutions through so-called "mark-to-market" accounting is not feasible because certain assets of banks and thrifts do not have the strong secondary markets necessary to determine current market values. Advocates argue, however, that while there are difficulties in implementing mark-to-market accounting, close approximations for regulatory purposes can usually be made. Such adjustments, while imperfect, improve upon the GAAP and RAP standards employed today.[7] Under a mark-to-market system of accounting, any institution whose market value fell below the minimum level would become subject to close regulatory oversight and perhaps certain restrictions. If the institution failed to recapitalize itself or find a merger partner within a short period of time, or if deterioration continued so that the institution's economic capital declined below a stipulated positive level, the institution would then be closed or merged with another institution.

Collateralizing Deposits

Requiring that institutions collateralize deposits is another approach that would impose more of the costs of risk taking on the institution. All insured deposits would have to be collateralized with assets of quality acceptable to the deposit insurance agency. Virtually any kind of asset could serve as collateral but the amount of collateral required would increase with the credit risk or interest-rate risk of the assets used. If the bank failed, the deposit insurance agency would take possession of the collateral whose value would be sufficient to pay the claims of insured depositors. The principal administrative problem for the deposit insurance agencies would therefore be looking after the value of collateral.

A precedent for collateralization exists within FHLBS. Savings institutions that are members of FHLBS must post collateral for all advances obtained from a Federal Home Loan bank. These advances totaled $116.3 on December 31, 1987, and constituted about 10 percent of the liabilities of FSLIC-insured institutions. Federal Home Loan banks have never experienced a loss on an advance despite all of the problems that have beset their member institutions.

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[7] Besides improving the information available to regulators, mark-to-market accounting would benefit banks and thrifts by helping them to focus on the true economic consequences of their decisions. In particular, it should help them focus on their sectoral diversification and their interest-rate risk exposure. Problems arising from such exposures would no longer be hidden. This information would remove a large amount of uncertainty from valuation of institutions.

Narrow Banking

A similar but more restrictive alternative to collateralizing deposits is the so-called "narrow bank" model.[a] The objective of narrow banking is to separate insured deposit taking from lending, thereby removing the ability to invest insured deposits in risky assets. Deposits in a narrow bank generally could only be invested in liquid, safe securities such as U.S. Treasury bills or other short-term marketable securities of high quality. Other activities of banking organizations would have to be financed by other means. The principal risk to deposited funds under this framework is that of fraud.

The concept of a narrow bank could be modified to include certain types of home-mortgage loan origination and financing activities that have low credit risk. However, in this case (or in the case of investments in longer term government securities) the deposit insurance premium could be adjusted to account for interest-rate and credit risk, and capital could be marked to market.

Drawbacks

The potential that these proposals have for transferring much of the cost of risk taking to those who take the risks and for running a deposit insurance system at a lower cost makes them especially promising.[b] However, they have possible drawbacks that need to be considered.

The first of these possible drawbacks is that these proposals may tend to reduce the role of depository institutions in providing longer term credit, especially credit at rates of interest that are fixed or that are not fully adjustable to changes in market interest rates. If deposits were collateralized, there may be a disincentive to engage in long-term lending if the amount of collateral required for a given level of deposits rises as the term to maturity of the collateral rises. Under a mark-to-market accounting regime, reluctance to engage in certain forms of longer term lending can be expected because the economic value of such loans is more sensitive to interest-rate fluctuations and changes in economic conditions than is the case with shorter term loans. Narrow banking would prohibit any expansion of credit funded by insured deposits beyond that which is very short term and of the highest quality.

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[a] Narrow banking is not a new idea but it has received renewed attention in recent years from advocates such as Robert Litan and James Tobin. See, for example, Robert E. Litan, What Should Banks Do?, The Brookings Institution, 1987. Also see James Tobin, "The Case for Preserving Regulatory Distinctions," in Restructuring the Financial System, a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 20-22, 1987, (pp. 167-183). Litan advocates narrow banking as a quid pro quo for expanding bank powers but Tobin advocates the model simply on its own merits. A narrow bank proposal such as Litan's would allow financial institutions to diversify into any financial or nonfinancial product line only if they separate deposit taking from lending. The narrow bank affiliate of the financial institution would accept insured deposits but would not make loans. Deposited funds would be invested only in liquid, safe securities. Banks not wishing to expand into activities beyond those currently allowed under the Bank Holding Company Act would continue to operate as they do today with the same deposit insurance. Banks under a certain size could be exempted from the necessity of forming a narrow bank affiliate in order to expand their activities under the premise that only large bank failures pose a problem to the insurance fund.

[b] Premiums would still be needed because institutions would still be susceptible to fraud, the insurance fund might make mistakes in estimating the condition of institutions, or relevant market values could change too rapidly for the insurance funds to take action. In addition, the insurance funds would still need funds to meet their own liquidity needs. However, in total, these demands would be far less than those now associated with bank or thrift failures.

Under the mark-to-market, collateralization, and narrow bank options, we would expect that banking organizations could still engage in intermediate or long-term lending. But we would also expect a significant reduction, if not complete elimination, in the use of insured bank deposits in funding such loans. Insured institutions would have greater incentives to make variable-rate loans, sell loans in the secondary market, and hedge risks with futures and options.

There is nothing inherently wrong with these incentives in that they would tend to make the insured institutions safer and therefore tend to reduce insurance fund losses. However, as a result of these changes, some alterations in the institutional arrangements for extending and financing credit can also be expected. For example, the traditional risk-taking role of banks—both with respect to interest-rate and credit risks—on balance would be reduced. Other sources of credit, such as pension funds, life insurance companies, and other intermediaries, may, however, be able to take over some of the long-term credit financing role now played by banks. Furthermore, revenues that banks would earn on insured deposits would be reduced to varying degrees because they would be invested in lower risk assets. In general, in financial markets rates of return are positively related to risk. Therefore, rates of interest paid on insured deposits would also be expected to decline. Because of the uncertainty that we have about how disruptive the changes might be to the credit allocation process, we believe that great care would have to be exercised in implementing any one of these deposit insurance reform alternatives.

A second, more important drawback of this group of reform proposals is that they may significantly impair the liquidity provision function of banks. This function has proven to be very important during periods of market turbulence—the last of which occurred during the market crash of 1987 when banks roughly doubled their lending to securities firms. This lending, buttressed by actions of the Federal Reserve, proved crucial in enabling securities firms to meet their obligations. If banks had not been able to lend at all, as would occur under the narrow bank proposal, or if collateralization requirements inhibited their ability to do so, the only remaining source of liquidity might have to be some form of direct Federal Reserve lending to nonbank firms.

Conclusion

There are practical difficulties associated with each of the reform proposals discussed in this appendix. The responses of depositors, depository institutions, and credit markets to any of these reforms is difficult to fully forecast. Nonetheless, each proposal offers solutions to at least some of the problems with our current system and each is worthy of serious consideration.

Appendix V

Administrative Aspects of a Merger

This appendix describes the effects a merger would have on the administrative matters pertaining to the operations of the insurance funds and identifies areas in which decisions must be made if a merger occurs.

FDIC and FSLIC present two models of the deposit insurance function. FDIC is more independent in its structure and operations. This type of "arms length" model of insurance requires coordination with federal and state regulatory and chartering authorities to be effective. FDIC appears to have been reasonably successful in working out such arrangements with OCC and the Federal Reserve. For state-chartered nonmember banks, FDIC has been aided by its role as the federal regulator and supervisor which enables it to have more direct control over these institutions.

In contrast, FSLIC is not independent but is governed by FHLBB. FHLBB, which is charged with promoting the availability of funds for home ownership, regulates the thrift industry and promotes the industry in its role as specialized housing lender. Federal Home Loan Bank personnel monitor institutions and attempt to resolve problems. Authority and control for all areas of FSLIC's operations rests with FHLBB.

FDIC has a sizable staff of its own employees working in Washington and in regional offices throughout the country. Staff needed for liquidation activity are hired on a temporary basis to assist permanent staff. FSLIC has a staff level of about 1/8 the size of FDIC; FHLBB performs the overhead functions and the Home Loan Banks handle the field work. In addition, FSLIC contracts out more of its receivership operations than does FDIC.

Table V.1 shows the relative sizes of FSLIC and FDIC staff and operating expenses.

Table V.1: Comparative Statistics on Size of FDIC and FSLIC

Dollars in millions

	FDIC	FSLIC
Corporate Full Time Staff Equivalents[a]	3,266	383
Total Corporate Personnel Compensation (FY 1987)	$105.7	$13.5
Corporate Administrative/Operating Expenses[a]	$200.8	$25.3[b]
Full Time Staff Involved in Liquidating Assets as of 2-29-88	4,072	850
Total Expense for Liquidation Operations CY 1987	$401	$228
Book Value of Assets Managed/Liquidated[c]	$12,274[d]	$5,688[e]

[a] Fiscal year 87 actual figures from fiscal year 1988 budget submission.

[b] FSLIC paid FHLBB $24.084 of this amount for providing certain services and facilities.

[c] The definitions of value used by the two agencies may not be comparable.

[d] Figure as of December 31, 1987.

[e] Figure is the sum of April 19, 1988, corporate FSLIC assets ($156) and February 29, 1988, FSLIC as a receiver assets ($5,532).

For purposes of the discussion in this appendix, we assume that merger of the deposit insurance funds would involve removing insurance authority from FHLBB but that chartering and primary supervisory authority for the thrift industry could remain with FHLBB. This could result in a relationship between the new insurance fund and FHLBB that would be comparable to FDIC's relationships with OCC, the Federal Reserve, or FHLBB itself with respect to some savings banks. For purposes of our discussion in this appendix, we will assume that FSLIC is either combined with FDIC or the two funds are combined in a new agency which would be formed around FDIC.

The sections that follow briefly discuss the following topics associated with a merger of FSLIC and FDIC:

- Executive structure of the agency.
- Powers of the insurance fund.
- Monitoring and examinations.

Executive Structure of the Agency

FDIC is governed by a board of three appointees. One is the Comptroller of the Currency. One of the other two serves as chairman. Terms of office are 5 years for the Comptroller and 6 years for the other appointees. No more than two of the directors can belong to the same political party.

If the funds are merged, decisions need to be made about the composition of the governing board. The current FDIC board could be expanded to provide representation for the Chairman of FHLBB. Alternatively, OCC could be dropped from the board or the board could be left unchanged because national banks have more assets than any other single group of depository institutions. If the board were too big, it might prove to be unwieldy.

Powers of the Insurance Fund

In chapter 5, we pointed out the importance of improving the management of the deposit insurance system's exposure to risk. In keeping with that discussion, if the deposit insurance funds are merged, the new entity needs to have sufficient powers and resources to be held accountable for the financial integrity of the fund.

The combined fund therefore needs to be able to

- adjust insurance premiums;
- deny insurance coverage or charge higher premiums to institutions engaged in activities that entail inordinate risk to the fund; and
- take actions, including expeditious termination of insurance, to enforce capital adequacy standards.

If the funds are merged, banks and thrifts, which could then receive comparable treatment in the insurance system, might still be subject to differing supervisory and regulatory systems that could put one industry at a competitive disadvantage with the other. Comparable standards on matters that are material to insurance fund losses are important to ensure that a fair balance be maintained between banks and thrifts with respect to premium levels, capital standards, allowable activities, and regulatory/supervisory rigor and to ensure that risks are adequately managed.

Monitoring and Examinations

Insurance funds can obtain data on institutions from financial reports submitted by the institution (off-site monitoring), by direct on-site examinations of the institution, or by reviewing examination reports made by bank supervisory agencies. Both FDIC- and FSLIC-insured institutions are required to file quarterly reports (call reports) with their principal federal supervisory agency. The content of the call reports for banks and thrifts are not identical. A merged fund needs the power to ensure that it has data sufficient to make comparable judgments about the condition of both banks and thrifts.

Currently, both FDIC and FHLBB evaluate the capital adequacy, asset quality, management, earnings, and liquidity of banks and thrifts by combining off-site monitoring with data provided by examinations. FDIC may also examine banks that the other regulators have indicated have problems in the course of regular examination. Examination frequency is based on the institution's last CAMEL rating. With a merger of the funds, the insurance agency would need at least the same power to examine potential problem thrifts that it has with respect to national or state member banks.

Recapitalization of the National Credit Union Share Insurance Fund

Our report discusses a good company/bad company merger of FSLIC and FDIC. We envision that recapitalization of the good company fund would be similar to the NCUSIF recapitalization under the Federal Credit Union Act amendment to the Omnibus Deficit Reductions Act of 1984 (Public Law 98-369). This appendix explains the key provisions of the NCUSIF arrangement and discusses briefly how the NCUSIF plan has worked thus far.

The NCUSIF Recapitalization

During the 1970s NCUSIF was funded primarily by annual premium assessments, from which it had built capital and reserves to 0.3 percent of insured shares in 1979—a level below the 1 percent level prescribed in the Federal Credit Union Act. Beginning in the late 1970s, NCUSIF faced financial problems because economic fluctuations, poor investments, and stiffer competition had caused a number of credit unions to fail. Reserve levels fell and remained below 0.3 percent through 1983 in spite of a special premium assessment which increased assessment income by 67 percent in 1982 and by 100 percent in 1983.

The Federal Credit Union Act amendment to the Omnibus Deficit Reduction Act of 1984 provided that a credit union applying for federal insurance would pay and maintain a deposit of 1 percent of the value of insured shares (deposits) with the insurance fund. The act also provided that the normal operating level for NCUSIF reserves would be determined by the NCUA Board. The Board has thus far set it at the maximum level prescribed in the act—1.3 percent of,insured deposits. The act also provided that credit unions would pay annual premiums of 1/12 of 1 percent if required by the NCUA Board to maintain the normal operating level after payment of insurance expenses. If reserves exceed the normal operating level, the Board could waive the subsequent insurance premium, rebate the previous premium, or distribute the excess amount to the credit unions as a dividend.

The NCUSIF plan had two key features. First, the 1-percent deposit is carried on each credit union's books as an asset and is fully refundable to the institution if insurance coverage is terminated, other insurance coverage is obtained, or if NCUSIF operations are transferred from NCUA. The deposit is not refunded if the institution is liquidated due to insolvency or bankruptcy. Like any asset, the deposit can be carried at full value so long as its value is not materially impaired. Therefore, so long as the insurance fund is not experiencing losses so large that it must use the 1-percent deposit to pay expenses, the cost to the credit unions of financing the insurance fund is equal to the net effect of the following items:

foregone income that could have been earned by investing the 1-percent deposit in other ways, the premiums avoided, and any dividend rebated by the insurance fund.

The second key feature of the NCUSIF plan is that the contribution by the credit unions was considered a revenue item for the fund and a revenue item for federal budget purposes primarily because all NCUSIF funds are maintained in an account with Treasury. Thus, when NCUSIF was recapitalized, the initial deposit resulted in a credit of $844 million[1] which was treated as revenue, thereby reducing the federal deficit and offsetting the deficit-increasing effect of expenditures on case resolutions.

Experience Under the Recapitalization Plan

The NCUSIF recapitalization seems to have worked well. NCUSIF reached its target operating level in the first year while simultaneously acting to resolve problem cases. The credit unions have not had to pay an annual insurance premium since the recapitalization—avoiding $387 million in premiums over the 1985-1988 period. (A 1-year waiver equals about an 8.3 percent dividend on the credit unions' 1-percent contribution.) The credit unions' investment in NCUSIF has not been at risk, so credit unions have been able to carry their contribution as a fully valued investment asset. From a federal budget perspective, NCUSIF recapitalization increased the government's net receipts over $800 million in 1985 and about $100 million in 1986.

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[1] The credit union actual payment was $760 million. The remainder of the $844 million represented the value of the premium waiver and a dividend for 1985 which were credited as part of the capital contribution.

FDIC and FSLIC Combined Financial Statements, December 31, 1987

FEDERAL DEPOSIT INSURANCE CORPORATION AND
FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
STATEMENTS OF FINANCIAL POSITION
DECEMBER 31, 1987
($ thousands)

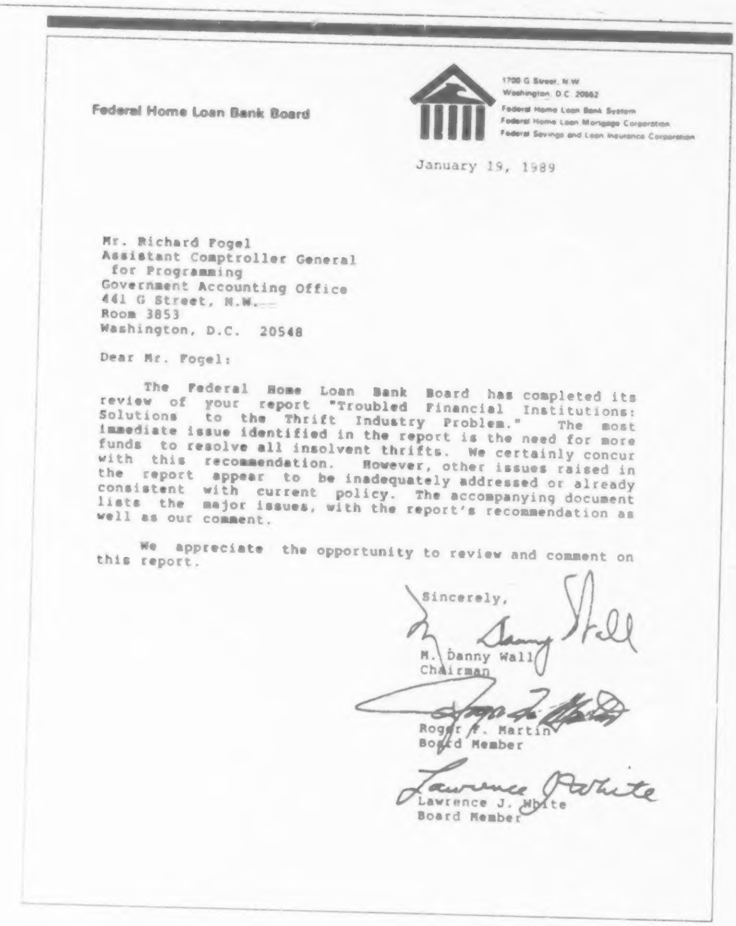
Assets	FDIC	FSLIC	FDIC+FSLIC
Cash	$18,499	$12,415	$30,914
Investment in U.S. treasury obs	16,098,874	3,357,173	19,456,047
Interest receivable on:			
Int rec on invest & oth assets	464,292	1,000	465,292
Int rec on lns to receivers		3,767	3,767
Int rec on oth lns to insured inst		10,533	10,533
Certs, notes & oth rec from insured inst:			
Income capital certificates		656,742	656,742
Net worth certificates		225,025	225,025
Other	557,638		557,638
Net rec from assistance to insured inst	1,664,515		1,664,515
RE mrtg lns oth assets in proc liq		173,437	173,437
Collateralized lns to insured inst		900,000	900,000
Other loans to insured institition		214,181	214,181
Net rec from failures of insured inst:	3,549,268		3,549,268
Subrogated accounts from receivers		3,988,495	3,988,495
Collateral advances from receivers		814,047	814,047
Loans to receivers		113,573	113,573
Other assets			
Other		19,009	19,009
Ins premiums and accts receivables		506	506
Contributions subject to repayment		18,544	18,544
Property and buildings	73,438		73,438
Total assets	$22,426,524	$10,508,447	$32,934,971
Liabilities and insurance fund reserves			
Accounts payable, accrued liab & other	$1,296,488	$102,230	$1,398,718
Assistance to failed or insured inst:			
Liab incurred assist insured inst	2,623,472		2,623,472
Liab incurred fails of insured inst	204,122		204,122
Note pay & oth liab to insured inst		4,947,463	4,947,463
Accr int on nts pay to insured inst		99,905	99,905
Notes payable to FHLBanks		900,000	900,000
Posble loss under exist asst agrmnts		749,069	749,069
Estimated loss from corp litigation	600		600
Estimated liability for unresolved cases		17,400,000	17,400,000
Total liabilities	$4,124,682	$24,198,667	$28,323,349
Insurance fund reserves			
Capital stock		$129,500	$129,500
Capital certificates		1,070,500	1,070,500
Primary reserve	$18,301,842	(14,890,220)	3,411,622
Total reserves	$18,301,842	($13,690,220)	$4,611,622
Total liabilities and reserves	$22,426,524	$10,508,447	$32,934,971

FEDERAL DEPOSIT INSURANCE CORPORATION AND
FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
CONSOLIDATED STATEMENT OF INCOME AND EXPENSE AND RESERVES
FOR THE YEAR ENDED DECEMBER 31, 1987
($ thousands)

INCOME	FDIC	FSLIC	FDIC+FSLIC
Insurance premiums	$1,697,208	$734,021	$2,431,229
Special assessment premiums	0	1,119,582	1,119,582
Gross assessments	1,697,208	1,853,603	3,550,811
Provision for assessment credits	1,250	0	1,250
Net assessments	1,695,958	1,853,603	3,549,561
Interest on investments	1,534,937	112,552	1,647,489
Other interest income:			
Interest on collateralized advances		8,814	8,814
Interest on advances to insured inst		47,051	47,051
Int on oth lns to insured inst		28,010	28,010
Int on collat lns to insured inst		101,240	101,240
Int mrtg lns oth assets in proc liq		17,159	17,159
Interest on NWC's & ICC's		60,607	60,607
Other income:			
Gain on transfer of insured account		31,710	31,710
Gain on sale of assets		32,299	32,299
Other	84,922	102,084	187,006
Total income	$3,315,817	$2,395,129	$5,710,946
EXPENSES			
Insurance settlement:			
Ins setlmnt & admin exp for FSLIC		$192,593	$192,593
Merger assistance losses & expense	$20,256		20,256
Nonrecoverable insurance expenses	47,732		47,732
Administrative expenses	202,381	25,604	227,985
Interest expense			
Int on notes payable to FHLBanks		78,928	78,928
Int notes payable to insured inst		237,789	237,789
Provision for possible future losses on:			
Subrogated accounts from receivers		1,623,060	1,623,060
Collateral advances from receivers		145,313	145,313
RE mortg lns & oth asts in proc liquid		106,943	106,943
Loans to receivers		24,225	24,225
Income capital certificates		281,793	281,793
Assistance agreements		1,334,730	1,334,730
Estimated losses for unresolved cases		6,900,000	6,900,000
Other	2,996,923		2,996,923
Total expenses	$3,267,292	$10,950,978	$14,218,270
Net income (loss) from operations	$48,525	($8,555,849)	($8,507,324)
Primary reserve at beginning of year	18,253,317	(6,332,891)	11,920,426
Secondary reserve adjustments		(1,480)	(1,480)
Capital stock		129,500	129,500
Capital certificates		1,070,500	1,070,500
Reserves at end of year	$18,301,842	($13,690,220)	$4,611,622

Appendix VIII

Comments From the Federal Home Loan Bank Board



Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

January 19, 1989

Mr. Richard Fogel
Assistant Comptroller General
for Programming
Government Accounting Office
441 G Street, N.W.
Room 3853
Washington, D.C. 20548

Dear Mr. Fogel:

The Federal Home Loan Bank Board has completed its review of your report "Troubled Financial Institutions: Solutions to the Thrift Industry Problem." The most immediate issue identified in the report is the need for more funds to resolve all insolvent thrifts. We certainly concur with this recommendation. However, other issues raised in the report appear to be inadequately addressed or already consistent with current policy. The accompanying document lists the major issues, with the report's recommendation as well as our comment.

We appreciate the opportunity to review and comment on this report.

Sincerely,

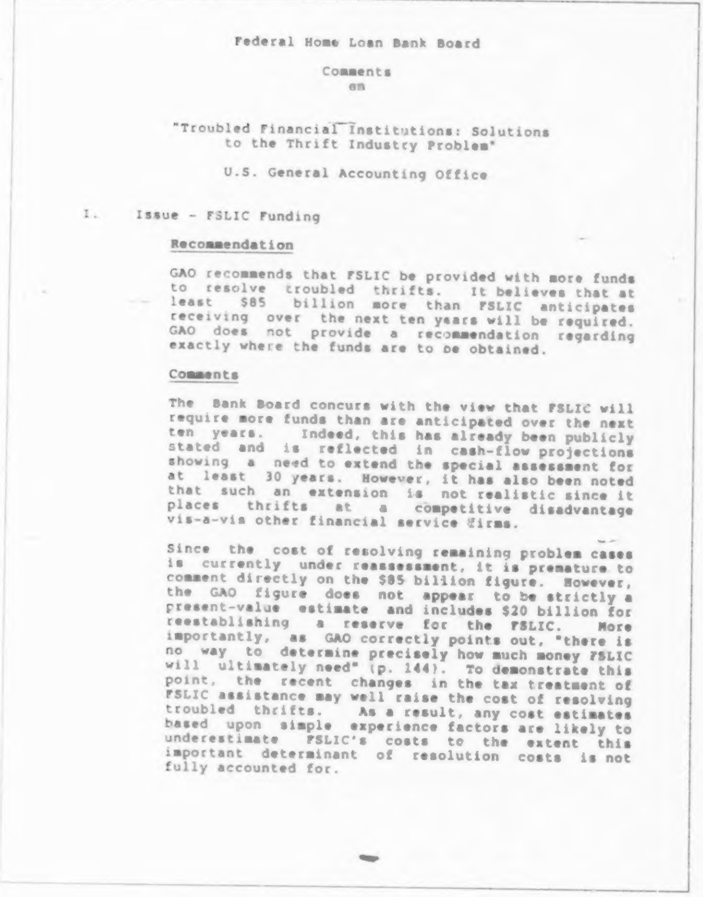
M. Danny Wall

M. Danny Wall
Chairman

Roger T. Martin
Board Member

Lawrence J White

Lawrence J. White
Board Member



Federal Home Loan Bank Board

Comments
on

"Troubled Financial Institutions: Solutions
to the Thrift Industry Problem"

U.S. General Accounting Office

I. Issue - FSLIC Funding

Recommendation

GAO recommends that FSLIC be provided with more funds to resolve troubled thrifts. It believes that at least $85 billion more than FSLIC anticipates receiving over the next ten years will be required. GAO does not provide a recommendation regarding exactly where the funds are to be obtained.

Comments

The Bank Board concurs with the view that FSLIC will require more funds than are anticipated over the next ten years. Indeed, this has already been publicly stated and is reflected in cash-flow projections showing a need to extend the special assessment for at least 30 years. However, it has also been noted that such an extension is not realistic since it places thrifts at a competitive disadvantage vis-a-vis other financial service firms.

Since the cost of resolving remaining problem cases is currently under reassessment, it is premature to comment directly on the $85 billion figure. However, the GAO figure does not appear to be strictly a present-value estimate and includes $20 billion for reestablishing a reserve for the FSLIC. More importantly, as GAO correctly points out, "there is no way to determine precisely how much money FSLIC will ultimately need" (p. 144). To demonstrate this point, the recent changes in the tax treatment of FSLIC assistance may well raise the cost of resolving troubled thrifts. As a result, any cost estimates based upon simple experience factors are likely to underestimate FSLIC's costs to the extent this important determinant of resolution costs is not fully accounted for.

Related to the funding issue is the treatment of FSLIC notes and guarantees. The extension of full faith and credit to these obligations would certainly reduce the costs imposed upon the FSLIC to resolve insolvent thrifts.

II. Issue - Merger of FSLIC and FDIC

Recommendation

GAO recommends against a merger of the insurance funds on the grounds that such a merger "cannot solve the FSLIC problem" (p.7).

Comments

The Bank Board concurs with the view that a simple merger of the insurance funds will not solve either the thrift or commercial bank problems. For this reason the Bank Board is proposing a complete reform of federal deposit insurance on the grounds that as it currently exists there is no provision for covering catastrophic losses (i.e., losses that swamp the reserves of an insurance fund). Establishment of a reinsurance-type entity would be one way to deal with the problem and be sure that no depository insurance fund be put into the same situation as the FSLIC has been in the last few years.

III. Issue - FSLIC Case Resolution Process

Recommendation

GAO criticizes the current case resolution process and recommends that it be changed. Instead of focusing on assisted mergers, it is recommended that insolvent institutions be temporarily placed in a receivership. In the interim, the risk-taking activities of these institutions should be contained and due diligence performed so as to enable one to determine the most appropriate disposal action.

Comments

The Bank Board believes this criticism and recommendation overlooks the fact that if the FSLIC were provided with more funds immediately--as the GAO recommends--the preferred course of action would indeed be assisted mergers to take advantage of a thrifts on-going value as reflected, for example, in its core deposits or mortgage-originations business.

However, at the margin, more cash would facilitate some additional liquidations. But with more funds there would simply be no need to adopt an interim strategy. Beyond this, it should be emphasized that all FSLIC's actions attempt to minimize the cost to the insurance fund. Liquidations, assisted mergers, MCPs and stabilizations are collectively designed to control risk-taking and provide proper incentives to reduce the ultimate cost to the FSLIC for resolving insolvent thrifts. Of course, FSLIC has been constrained by the resources--both human and monetary--available to it. It must also follow procedures established by law and regulation.

Experience also indicates that temporary receiverships do not really resolve problems. Tight supervision and careful monitoring of assisted mergers is a far more preferable strategy.

In any event, GAO's criticism of the case resolution process is not supported by any factual information. This is perhaps not surprising since the report admits that GAO has just "begun work to assess in detail the merger and other resolutions of specific insolvent thrifts that have occurred" (p.78). More importantly, the recommendation itself is entirely consistent with the current FSLIC case resolution process and Bank Board policies--such as growth limitations and asset restrictions--designed to control risk-taking activities. Recently, moreover, the Bank Board proposed a new minimum capital regulation and early intervention rule that will protect the FSLIC from future losses. In addition to ongoing examinations at insolvent thrifts, MCPs and stabilizations specifically permit due diligence so as to determine the least costly disposal action. More specifically, the recent actions involving Silverado and several thrifts in Oklahoma appear to be exactly the type of transactions being recommended by GAO. Performing due diligence before taking action would only slow the resolution process when the need to act is now.

IV. Issue - Restructuring the FSLIC

Recommendation

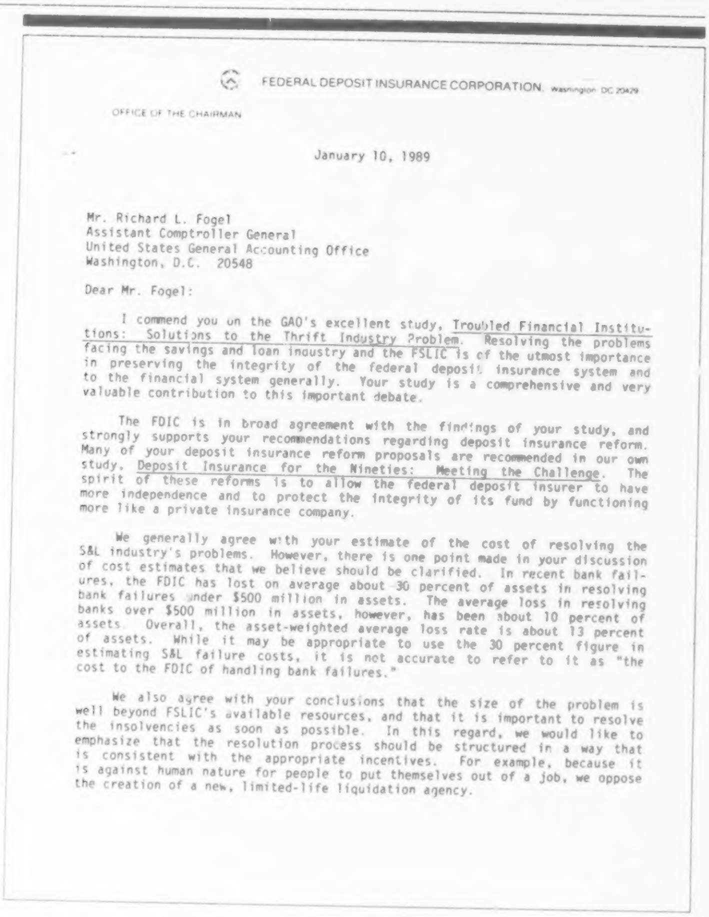
GAO recommends that FSLIC "be reorganized under independent management [i.e., removed from the jurisdiction of the FHLBB] so that it consists of two parts: a 'good company' fund for thrifts that are healthy or can become so in a reasonable period of time, and a 'bad company' fund for those institutions that need to be rehabilitated, merged or liquidated" (p.5). Furthermore, "healthy thrifts that meet FDIC's capital adequacy criteria should be offered a choice of joining the FDIC or the good company fund" (p.5).

Comments

In recommending a management structure similar to the bank regulators, GAO fails to justify the need for a separate chartering authority and insuring authority and how such independence improves regulatory oversight and supervision. More generally, even if FSLIC is managed independently of the Bank Board, it would have to operate in cooperation with them and also with state chartering agencies, as the FDIC must operate with the OCC, the Federal Reserve Board, and the state banking agencies. If the Bank Board "promotes" the thrift industry and thereby makes decisions that are biased, it would seem to be critical to correct this bias, regardless of the administrative status of FSLIC. Besides, with separate agencies the industry would be in a position to play one agency against the other.

Lastly, this particular recommendation does not actually establish a structure, such as a reinsurance entity, that assures the current depository insurance system problems will not recur.

Comments From the Federal Deposit Insurance Corporation



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

OFFICE OF THE CHAIRMAN

January 10, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

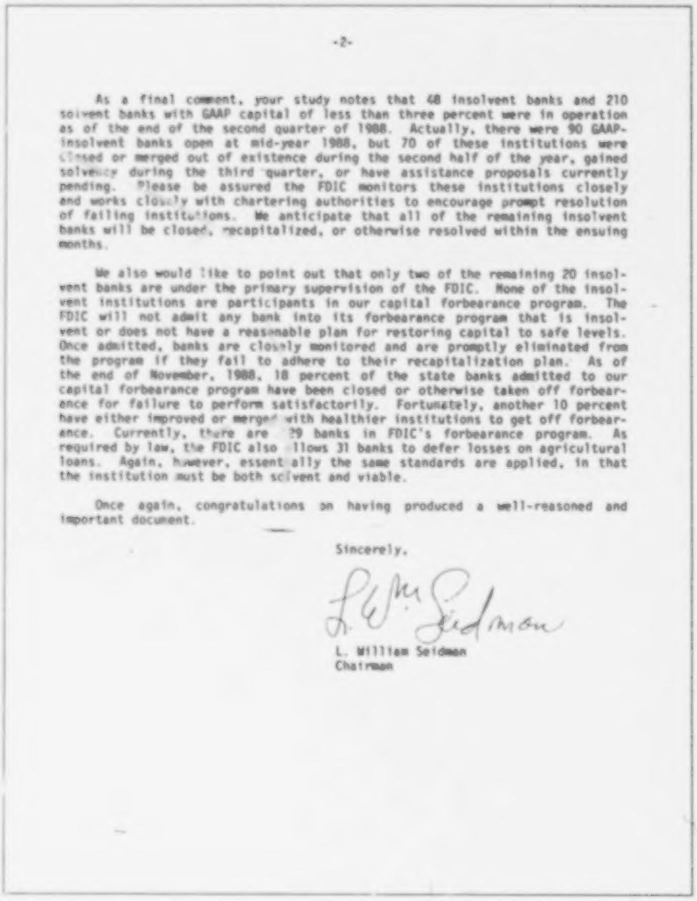
Dear Mr. Fogel:

I commend you on the GAO's excellent study, Troubled Financial Institutions: Solutions to the Thrift Industry Problem. Resolving the problems facing the savings and loan industry and the FSLIC is of the utmost importance in preserving the integrity of the federal deposit insurance system and to the financial system generally. Your study is a comprehensive and very valuable contribution to this important debate.

The FDIC is in broad agreement with the findings of your study, and strongly supports your recommendations regarding deposit insurance reform. Many of your deposit insurance reform proposals are recommended in our own study, Deposit Insurance for the Nineties: Meeting the Challenge. The spirit of these reforms is to allow the federal deposit insurer to have more independence and to protect the integrity of its fund by functioning more like a private insurance company.

We generally agree with your estimate of the cost of resolving the S&L industry's problems. However, there is one point made in your discussion of cost estimates that we believe should be clarified. In recent bank failures, the FDIC has lost on average about 30 percent of assets in resolving bank failures under $500 million in assets. The average loss in resolving banks over $500 million in assets, however, has been about 10 percent of assets. Overall, the asset-weighted average loss rate is about 13 percent of assets. While it may be appropriate to use the 30 percent figure in estimating S&L failure costs, it is not accurate to refer to it as "the cost to the FDIC of handling bank failures."

We also agree with your conclusions that the size of the problem is well beyond FSLIC's available resources, and that it is important to resolve the insolvencies as soon as possible. In this regard, we would like to emphasize that the resolution process should be structured in a way that is consistent with the appropriate incentives. For example, because it is against human nature for people to put themselves out of a job, we oppose the creation of a new, limited-life liquidation agency.



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As a final comment, your study notes that 48 insolvent banks and 210 solvent banks with GAAP capital of less than three percent were in operation as of the end of the second quarter of 1988. Actually, there were 90 GAAP-insolvent banks open at mid-year 1988, but 70 of these institutions were closed or merged out of existence during the second half of the year, gained solvency during the third quarter, or have assistance proposals currently pending. Please be assured the FDIC monitors these institutions closely and works closely with chartering authorities to encourage prompt resolution of failing institutions. We anticipate that all of the remaining insolvent banks will be closed, recapitalized, or otherwise resolved within the ensuing months.

We also would like to point out that only two of the remaining 20 insolvent banks are under the primary supervision of the FDIC. None of the insolvent institutions are participants in our capital forbearance program. The FDIC will not admit any bank into its forbearance program that is insolvent or does not have a reasonable plan for restoring capital to safe levels. Once admitted, banks are closely monitored and are promptly eliminated from the program if they fail to adhere to their recapitalization plan. As of the end of November, 1988, 18 percent of the state banks admitted to our capital forbearance program have been closed or otherwise taken off forbearance for failure to perform satisfactorily. Fortunately, another 10 percent have either improved or merged with healthier institutions to get off forbearance. Currently, there are 29 banks in FDIC's forbearance program. As required by law, the FDIC also allows 31 banks to defer losses on agricultural loans. Again, however, essentially the same standards are applied, in that the institution must be both solvent and viable.

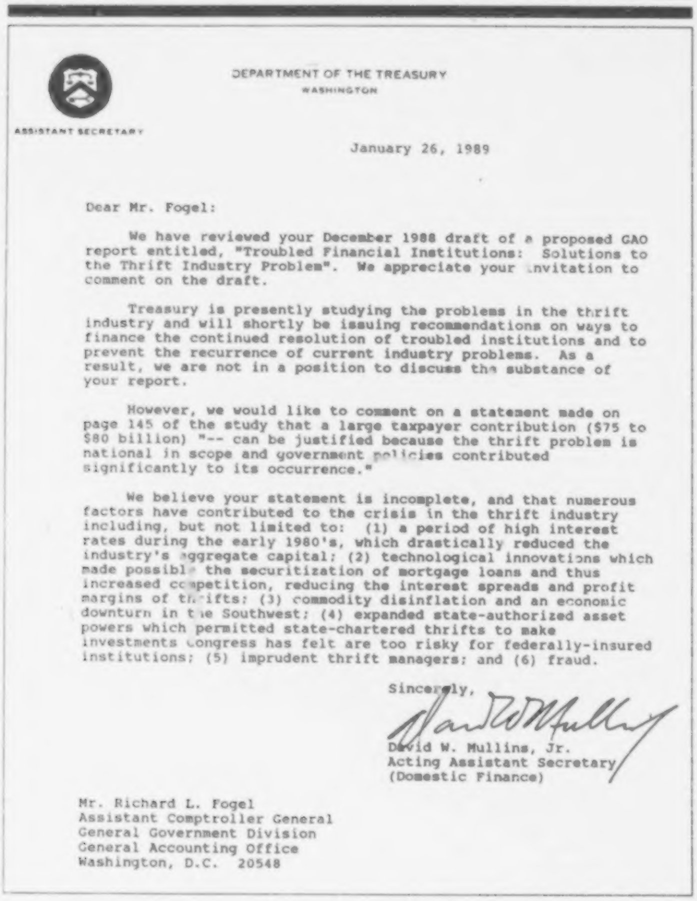
Once again, congratulations on having produced a well-reasoned and important document.

Sincerely,

L. Wm Seidman

L. William Seidman
Chairman

Comments From the Department of the Treasury



DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

January 26, 1989

Dear Mr. Fogel:

We have reviewed your December 1988 draft of a proposed GAO report entitled, "Troubled Financial Institutions: Solutions to the Thrift Industry Problem". We appreciate your invitation to comment on the draft.

Treasury is presently studying the problems in the thrift industry and will shortly be issuing recommendations on ways to finance the continued resolution of troubled institutions and to prevent the recurrence of current industry problems. As a result, we are not in a position to discuss the substance of your report.

However, we would like to comment on a statement made on page 145 of the study that a large taxpayer contribution ($75 to $80 billion) "-- can be justified because the thrift problem is national in scope and government policies contributed significantly to its occurrence."

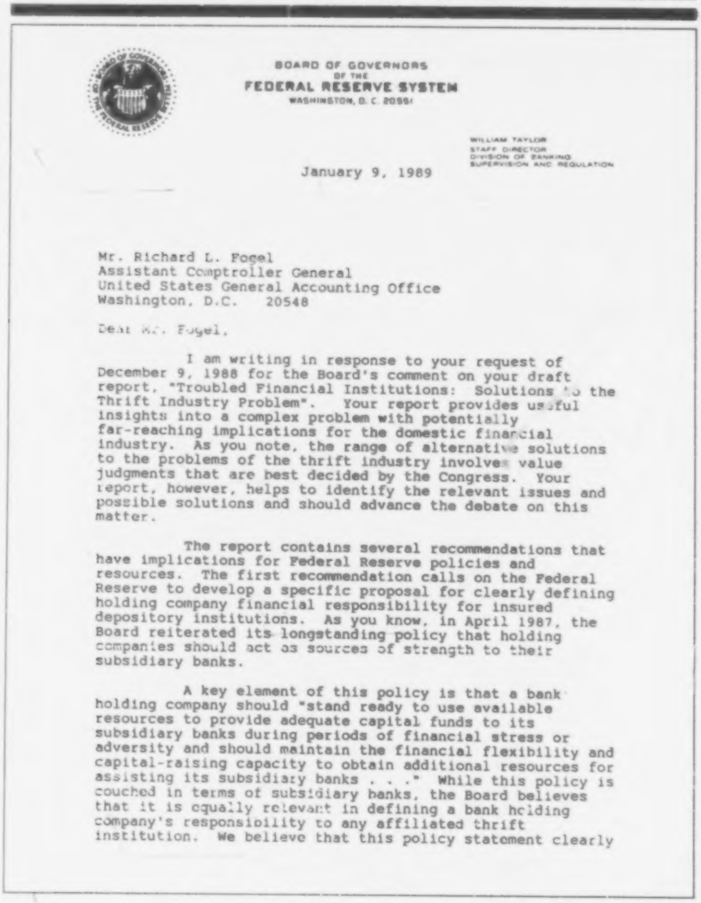
We believe your statement is incomplete, and that numerous factors have contributed to the crisis in the thrift industry including, but not limited to: (1) a period of high interest rates during the early 1980's, which drastically reduced the industry's aggregate capital; (2) technological innovations which made possible the securitization of mortgage loans and thus increased competition, reducing the interest spreads and profit margins of thrifts; (3) commodity disinflation and an economic downturn in the Southwest; (4) expanded state-authorized asset powers which permitted state-chartered thrifts to make investments Congress has felt are too risky for federally-insured institutions; (5) imprudent thrift managers; and (6) fraud.

Sincerely,

David W. Mullins, Jr.
Acting Assistant Secretary
(Domestic Finance)

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
General Accounting Office
Washington, D.C. 20548

Comments From the Board of Governors of the Federal Reserve System



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

WILLIAM TAYLOR
STAFF DIRECTOR
DIVISION OF BANKING
SUPERVISION AND REGULATION

January 9, 1989

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel,

I am writing in response to your request of December 9, 1988 for the Board's comment on your draft report, "Troubled Financial Institutions: Solutions to the Thrift Industry Problem". Your report provides useful insights into a complex problem with potentially far-reaching implications for the domestic financial industry. As you note, the range of alternative solutions to the problems of the thrift industry involves value judgments that are best decided by the Congress. Your report, however, helps to identify the relevant issues and possible solutions and should advance the debate on this matter.

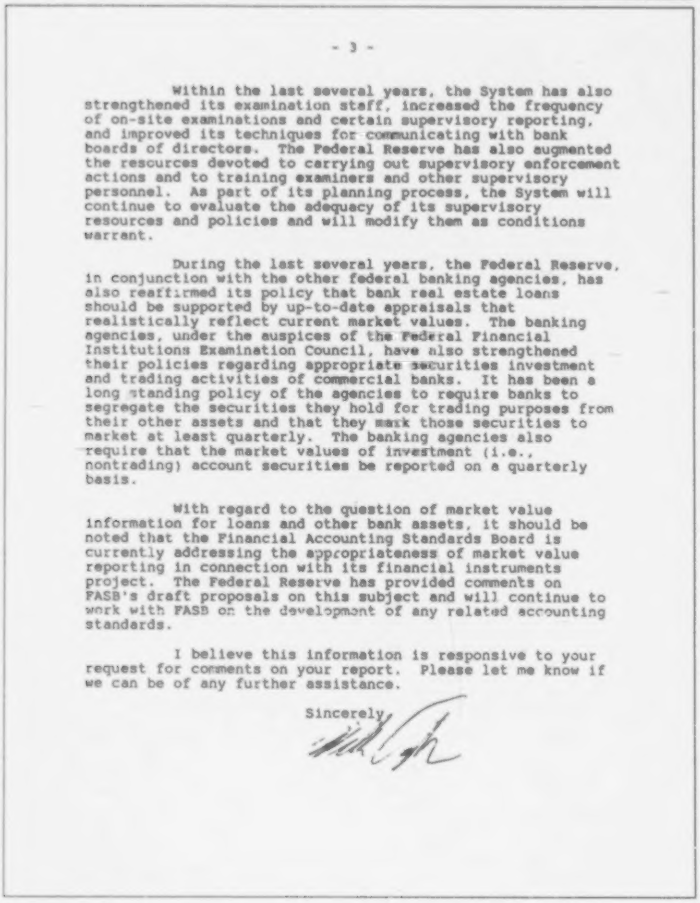
The report contains several recommendations that have implications for Federal Reserve policies and resources. The first recommendation calls on the Federal Reserve to develop a specific proposal for clearly defining holding company financial responsibility for insured depository institutions. As you know, in April 1987, the Board reiterated its longstanding policy that holding companies should act as sources of strength to their subsidiary banks.

A key element of this policy is that a bank holding company should "stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks . . ." While this policy is couched in terms of subsidiary banks, the Board believes that it is equally relevant in defining a bank holding company's responsibility to any affiliated thrift institution. We believe that this policy statement clearly affirms the Board's commitment to the principle that a bank holding company should serve as a source of strength to any insured depository institution subsidiary.

A second recommendation in your report is that the Federal Savings and Loan Insurance Corporation request help from the federal banking agencies in examining certain savings and loan institutions on a short-term basis. The Federal Reserve recognizes the magnitude and complexity of the problems facing the thrift industry and is certainly willing to play a constructive and appropriate role in addressing the situation. As noted in your report, in 1985 the Federal Reserve worked closely with examination and supervisory personnel from the Federal Home Loan Bank Board and state examination departments to monitor conditions and assess problems in non-Federally insured thrift institutions during the Ohio and Maryland thrift crises. The Federal Reserve remains ready to provide an appropriate measure of assistance to other Federal and state regulators, consistent with our available resources and our responsibilities for promoting safe and sound conditions within the banking and financial system.

The report further indicates that the financial institution regulatory agencies should strengthen their capital adequacy standards and their supervisory capability, and that they should obtain better information about the market values of financial institutions. The Federal Reserve whole-heartedly supports these recommendations. As you know, the Federal Reserve and the other federal bank regulatory agencies. in cooperation with authorities abroad, have recently taken steps to strengthen capital standards by adopting new capital standards that relate an institution's capital requirements directly to the estimated risks it undertakes. The Board's specific standards relate to bank holding companies and state member banks and will go into effect next month. Other elements of the standard, such as factoring interest rate risk into the measure, are still being developed and should lead to further improvement in the capital adequacy of U.S. banking organizations.

The Federal Reserve has also emphasized capital adequacy in reviewing bank dividend policies and in evaluating plans to undertake significant expansion. In this regard, the Board has required banking organizations undertaking significant growth or expansion to operate with capital positions well above supervisory minimums and has generally not permitted institutions to reduce their financial strength in order to fund expansion proposals.



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Within the last several years, the System has also strengthened its examination staff, increased the frequency of on-site examinations and certain supervisory reporting, and improved its techniques for communicating with bank boards of directors. The Federal Reserve has also augmented the resources devoted to carrying out supervisory enforcement actions and to training examiners and other supervisory personnel. As part of its planning process, the System will continue to evaluate the adequacy of its supervisory resources and policies and will modify them as conditions warrant.

During the last several years, the Federal Reserve, in conjunction with the other federal banking agencies, has also reaffirmed its policy that bank real estate loans should be supported by up-to-date appraisals that realistically reflect current market values. The banking agencies, under the auspices of the Federal Financial Institutions Examination Council, have also strengthened their policies regarding appropriate securities investment and trading activities of commercial banks. It has been a long standing policy of the agencies to require banks to segregate the securities they hold for trading purposes from their other assets and that they mark those securities to market at least quarterly. The banking agencies also require that the market values of investment (i.e., nontrading) account securities be reported on a quarterly basis.

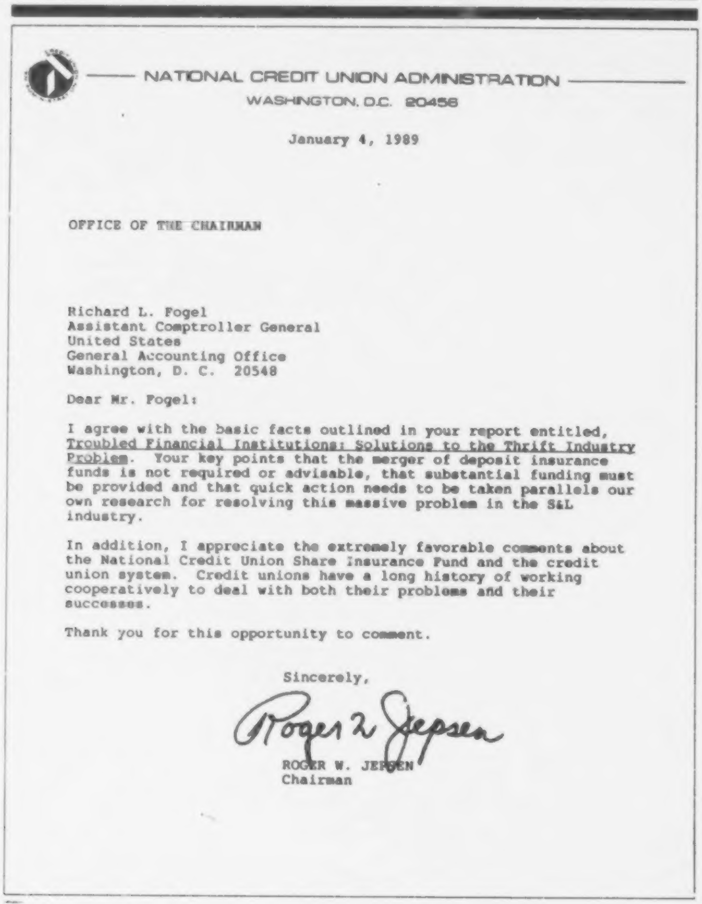
With regard to the question of market value information for loans and other bank assets, it should be noted that the Financial Accounting Standards Board is currently addressing the appropriateness of market value reporting in connection with its financial instruments project. The Federal Reserve has provided comments on FASB's draft proposals on this subject and will continue to work with FASB on the development of any related accounting standards.

I believe this information is responsive to your request for comments on your report. Please let me know if we can be of any further assistance.

Sincerely,

Appendix XII

Comments From the National Credit Union Administration



NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

January 4, 1989

OFFICE OF THE CHAIRMAN

Richard L. Fogel
Assistant Comptroller General
United States
General Accounting Office
Washington, D. C. 20548

Dear Mr. Fogel:

I agree with the basic facts outlined in your report entitled, Troubled Financial Institutions: Solutions to the Thrift Industry Problem. Your key points that the merger of deposit insurance funds is not required or advisable, that substantial funding must be provided and that quick action needs to be taken parallels our own research for resolving this massive problem in the S&L industry.

In addition, I appreciate the extremely favorable comments about the National Credit Union Share Insurance Fund and the credit union system. Credit unions have a long history of working cooperatively to deal with both their problems and their successes.

Thank you for this opportunity to comment.

Sincerely,

Roger W Jepsen

ROGER W. JEPSEN
Chairman

Appendix XIII

Related GAO Products

Commercial Banking Supervision and Regulation

Failed Banks: FDIC's Asset Liquidation Operations (GAO/GGD-88-132, Sept. 28, 1988).

Budget Issues: Information on FDIC and FSLIC Notes Payable (GAO/AFMD-88-71FS, Aug. 5, 1988).

Commercial Banking: Trends in Performance From December 1976 Through June 1987 (GAO/GGD-88-106BR, July 28, 1988).

Financial Audit: Federal Deposit Insurance Corporation's 1987 and 1986 Financial Statements (GAO/AFMD-88-43, Apr. 22, 1988).

Bank Powers: Issues Related to Repeal of the Glass-Steagall Act (GAO/GGD-88-37, Jan. 22, 1988).

Deposit Insurance: Analysis of Reform Proposals (GAO/GGD-86-32, 32a, 32b, Sept. 30, 1986).

Thrift Industry

Financial Audit: Federal Savings and Loan Corporation's 1987 and 1986 Financial Statements (GAO/GGD-88-67, Aug. 24, 1988).

Thrift Industry: Trends in Thrift Industry Performance: December 1977 Through June 1987 (GAO/GGD-88-87BR, May 17, 1988).

Thrift Industry: Federal Home Loan Bank Board Advances Program (GAO/GGD-88-46BR, Mar. 9, 1988).

Thrift Industry: Forbearance for Troubled Institutions 1982-1986 (GAO/GGD-87-78BR, May 6, 1987).

Thrift Industry: The Management Consignment Program (GAO/GGD-87-115BR, Sept. 10, 1987).

Thrift Industry: The Treasury/Home Loan Bank Board Plan for FSLIC Recapitalization (GAO/GGD-87-46BR, Mar. 3, 1987).

Thrift Industry: Cost to FSLIC of Delaying Action on Insolvent Savings Institutions (GAO/GGD-86-122BR, Sept. 9, 1986).

Testimony

"Resolving the Savings and Loan Crisis," (GAO-T-GGD-89-4, Feb. 2, 1989).

"Resolving the Savings and Loan Crisis," (GAO-T-GGD-89-3, January 26, 1989).

"Failed Financial Institutions: Reasons, Costs, Remedies and Unresolved Issues," (GAO-T-AFMD-89-1, Jan. 13, 1989).

"Budgetary Implications of the Savings and Loan Crisis," (GAO/T-AFMD-88-19, Oct. 5, 1988).

"Safeguards that Need to Accompany Changes to Glass-Steagall Laws," (GAO/T-GGD-88-51, Sept. 13, 1988).

"The Federal Savings and Loan Insurance Corporation's Use of Notes and Assistance Guarantees," (GAO/T-AFMD-88-17, Sept. 8, 1988).

"The Federal Savings and Loan Insurance Corporation—Current Financial Condition and Outlook," (GAO/T-AFMD-88-12, May 19, 1988).

Other

Guidelines for Rescuing Large Failing Firms and Municipalities (GAO/GGD-84-34, Mar. 29, 1984).

Appendix XIV

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CRISIS RESOLUTION IN THE THRIFT INDUSTRY:

BEYOND THE DECEMBER DEALS

Report of the

Mid America Institute Task Force on the Thrift Crisis

March 3, 1989

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PREFACE

On February 6, 1989, the Federal Home Loan Bank Board contacted Mid America Institute to inquire whether it would undertake an independent, academically oriented analysis of the insolvency resolution crisis in the thrift industry. The Senate Banking Committee, during the course of hearings on the thrift crisis, had suggested to the Bank Board the desirability of an independent assessment of Bank Board and FSLIC resolution methodology, specifically as it related to the controversy surrounding the December deals, the Southwest Plan, and the possibility that tax considerations were driving certain deals.

The Bank Board had already initiated studies from industry-oriented perspectives. Therefore, it felt that an academic perspective would provide both a valuable addition to the process, and by the nature of academia, perhaps the best prospect of a credible and independent viewpoint.

The Bank Board was prepared to give an appropriately structured Task Force virtually unlimited access to all personnel, documents and resources that the Task Force felt necessary to come to an uncompromising assessment. The only significant constraint imposed was that a report had to be available prior to the start of the next round of Senate Banking Committee hearings on March 1, 1989. The Task Force would be given complete discretion as to the scope and coverage of the report, but it was requested that the topic of the December deals, particularly the associated tax considerations, be a significant part of the report.

On February 7, 1989 Mid America Institute started the process of putting together a team capable of undertaking the demanding task of generating the necessary information, analyzing it in detail, arriving at a coherent understanding of the issue, developing conclusions and recommendations based

on that understanding, and finally writing a comprehensive report--all in the space of less than three weeks. Mid America Institute decided early on, with the complete agreement of the Bank Board, that the objectives of independence and credibility would be best served if the Task Force were composed of world renowned scholars, with broad expertise, who had not as yet entered the policy debate either through written work on the thrift crisis, through consulting work, or through public policy testimony.

Mid America Institute also recognized that such scholars would not be able, on such short notice, to free up sufficient time to undertake the full responsibility for all aspects of the study. With this consideration in mind, the Institute designed a two-tier structure for the Task Force, comprised of a Core Staff and a Resource Panel. Roger Kormendi, Research Director of Mid America Institute and Associate Professor of Business Economics at the School of Business Administration of the University of Michigan, agreed to head the Core Staff. To maximize the efficiency of the Core Staff's activity, he was joined by his University of Michigan colleagues Victor Bernard, Professor of Accounting, Craig Pirrong, Assistant Professor of Business Economics, and Edward Snyder, Assistant Professor of Business Economics.

The Resource Panel would be comprised of nine leading scholars from the fields of Accounting, Economics, Finance, Mergers and Acquisitions, and Taxation. The panel includes William Beaver (Stanford), Michael Bradley (Michigan), Kenneth French (Chicago), Robert Merton (Harvard), Merton Miller (Chicago), Katherine Schipper (Chicago), Myron Scholes (Stanford), Roman Weil (Chicago) and Mark Wolfson (Stanford, on leave at Harvard and M.I.T.).

The Core Staff accepted specific responsibility for (1) obtaining all of the information necessary for the analysis through interviews with relevant Bank Board and FSLIC personnel, as well as gathering relevant documents, material and data; (2) processing and consolidating this information so as to provide the Resource Panel with an efficient subset of this information; and (3) developing the initial outline of the issues and the specific tasks needed to complete the project. This was accomplished over the course of six days, February 9 through 14. In addition to interviews with the Bank Board and the FSLIC, the Core Staff met or spoke with persons at the Treasury, OMB, GAO and the staff of the Senate Banking Committee. The Core Staff also met or spoke with legal counsel for several acquirers and big eight accounting firms that offered consulting services to acquirers.

The Core Staff sent the information on to the members of the Resource Panel. Over the course of February 12 through 17, the members of the Panel analyzed and discussed the information among themselves and with the Staff. Taking advantage of proximity, two working subgroups formed: one at Harvard (Merton and Wolfson), and one at Stanford (Beaver, Scholes and Weil). Members of the Core Staff met with these subgroups for extensive discussions on February 16 and 17. The Core Staff then accepted responsibility for producing a first draft that assimilated the ideas, perspectives, analyses and conclusions that were to emerge from the extended interactions between the Panel and the Core Staff.

That document, benefiting from continued interaction with the Resource Panel, was made available February 22 to the Panel. The comments and suggestions of the Panel were incorporated on an ongoing basis, throughout the course of subsequent.

On February 23 a revised draft was made available, at Bank Board request, to three Bank Board economists (including Board Member Larry White). On February 25, a Draft Report was made available to the Bank Board for more general internal distribution. As per the terms of the agreement with the

Bank Board, the extent to which comments and suggestions of the Bank Board were incorporated into the Final Report was at the sole discretion of the Task Force.

The comments and suggestions received by the Task Force from the Bank Board and its staff were informative, interesting, well-motivated and intellectually sound. The Final Report benefited significantly from the professional approach taken by the Bank Board with respect to this review phase. At no time did the Task Force feel any pressure to modify its analysis, conclusions or recommendations for any reasons other than economic logic or factual accuracy.

At all stages of the investigation, the staff and personnel of the Bank Board and FSLIC gave utmost priority to meeting the needs of the Task Force for information, documents, data and personal consultations. In all respects, the Bank Board and FSLIC cooperated with the objectives of this study to the fullest extent possible. Given the very short span of time available to complete this study, anything short of complete access and full cooperation could easily have foiled the process of inquiry, even without directly appearing to do so. The Bank Board and the FSLIC are to be commended for providing a model for enabling an independent academic panel to undertake its task successfully and efficiently.

By the very nature of the time constraints involved, this Report is not intended to provide a definitive assessment of all issues relating to insolvency resolution in 1988. Of necessity the Report considers some topics in detail at the expense of others. Although we have touched at least briefly on most of the important economic issues associated with insolvency resolution, certain issues that impact the resolution process must remain outside the scope of this Report. For example, in 1988, FSLIC was operating under significant budgetary and political constraints. Although we have attempted to address in the Report the consequences of budget constraints on the resolution process, we have not focused our analysis on such constraints in part because these may be temporary. Nor have we focused on relevant political constraints. Undoubtedly, political constraints, budgetary constraints, and general institutional constraints place limits on feasible "real world" outcomes. Our perspective in this regard has been to raise certain issues, ask new questions, suggest partial answers, and provide directions for further study in an attempt to contribute to the overall task of designing policies to deal with the current crisis.

ACKNOWLEDGEMENTS

We would like to acknowledge the help of significant contributors to the success of this report: Philip Maguire (University of Michigan), Ida Walters (Mid America Institute), and Harry Watson (Mid America Institute) for their contributions to both substantive content and exposition; Philip Maguire, for his assistance in organizing the dataset and performing the calculations; Dick Jobes and Tom Lechner (both from the University of Michigan) for research assistance; Bernadine Gibson (Mid America Institute) and Mary Hardy (University of Michigan) for their efforts to coordinate Task Force operations; and Margaret Oberle (University of Michigan) for typing the document faster than we could produce it.

OBSERVATIONS, CONCLUSIONS, AND RECOMMENDATIONS

Section I: Introduction and Overview

1. The FSLIC insurance contract is correctly viewed as a put option. When thrifts become insolvent, the contract permits thrifts to "put" their insured deposits to the government, which then becomes obligated for these liabilities. The value of this put option increases with the riskiness of the underlying assets, but the rates charged by the government do not vary to reflect the riskiness of individual thrifts. Thus, there is a structural incentive for thrifts to take on more risk.

2. Economic events during the early 1980s, particularly increased volatility of interest rates, made the put option more valuable and increased the government's exposure to risk. In addition, as adverse interest rate spreads led to reduced levels of capital, thrifts could increase risk-taking with little at stake (heads I win, tails I break even). The result was a greater incentive to assume risk.

3. Within this context, the optimal regulatory response would have been to increase monitoring, and to increase premia on deposit insurance to account for the greater risk.

4. In fact, in the early 1980s, thrifts were granted regulatory forbearances and capital reserve requirements were liberalized. In addition, the Garn-St Germain Depository Institutions Act of 1982 allowed thrifts to go beyond their traditional asset base of fixed rate mortgages of one to four family dwellings. In the face of this increase in risk exposure, FSLIC did not raise premiums until 1985.

5. The severe "Texas bust" had a disproportionate impact on thrifts because they were overexposed to the risks of such an event. This overexposure was a direct consequence of the incentives for risk-taking created by deposit insurance.

6. In recent years the FHLBB has raised deposit insurance premiums, has moved toward risk based capital requirements, and has taken steps to control equity investments by S&Ls, reform accounting practices, and double the number of examiners at the district bank level to improve monitoring.

7. Unless the underlying problems with the pricing of deposit insurance are dealt with as part of the solution to the current crisis, there will undoubtedly be future shocks that create future crises. Therefore, risk based premia and higher capital requirements for high risk investments should be introduced as features of the insurance contract.

Section II: The Timeliness of Regulatory Action and the Growing Net Worth Deficit

1. The cost of deferring the resolution of an insolvent thrifts depends on the rate at which its net worth deficits grow. However, only real deficit growth in excess of the rate of interest (on a security of similar risk) constitutes an additional loss to society.

2. Interpreting the rate of growth of the net worth deficit of insolvent thrifts is difficult, in part because the underlying accounting systems recognize changes in market values only with delays, often of several years.

3. Problems relating to the transfer of accurate information from District Banks to FSLIC may also impair the resolution process. FSLIC does not possess adequate resources to collect and process all the necessary information for efficient transitional management and ultimate disposition of a thrift.

4. FSLIC has taken several positive steps to control the growth of the net deficit. Its development of the Management Consignment Program reflects an understanding of the need to stem hole growth while awaiting final resolution.

5. Management incentives to take risk (and thereby raise the expected value of FSLIC's obligation) are most acute when a thrift is thinly capitalized. Therefore, an objective, observable threshold to trigger corrective action should be established, and action should occur once that threshold is reached unless (within a specified period of time) thrift management presents a compelling case that it is unnecessary.

6. FSLIC and the FHLBB should prevent insolvent institutions from offering above-market premiums to attract deposits. This would require FSLIC to provide liquidity to troubled thrifts in order to allow them to pay interest and withdrawals on existing deposits. At this time FSLIC lacks sufficient reserves for this purpose.

7. Information systems should be improved, so that FSLIC can identify troubled thrifts at an earlier stage. An improved mark-to-market accounting system for thrifts would be important in this regard, and is feasible. Research programs to analyze the sources of the existing net deficit, to forecast future levels of the net deficit, and to identify and prioritize cases for resolution should be improved.

Section III: Resolution of Insolvent Thrifts: Fundamental Issues

1. Some insolvent thrifts may possess marketing advantages in competing for depositors and borrowers. These advantages may make the thrifts viable as ongoing institutions. This value as a continuing institution is called franchise value.

2. In those cases where franchise value does exist, a policy of liquidation could be excessively costly. FSLIC could capture some (if not all) of the franchise value inherent in a thrift through an assisted acquisition.

3. Franchise value is intangible and hard to measure directly. However, a competitive bidding process can help identify franchise value. Effective use of the competitive bidding process requires FSLIC to evaluate and compare the cost of the various resolution alternatives. Improper evaluations of bid terms can lead FSLIC to accept more costly bids, to sell a thrift that should be liquidated, or to liquidate one that should be sold.

4. Inclusion of tax benefits in assistance packages makes it difficult for the bidding process to reveal franchise value. Some bids reflect the value of the tax benefits, rather than the value of the thrift's operations. To avoid this, tax benefits should not be granted to acquirers.

5. FSLIC's limited cash reserves have affected its ability to liquidate insolvent thrifts with cash. In principal, FSLIC could issue notes to finance liquidations, but it has had to pay what it considers to be excessively high rates to place notes. The higher rates on notes used in liquidation, as opposed to assisted acquisition, reflect the fact that the former are taxable, whereas the latter are not. From a consolidated government perspective, FSLIC should be indifferent between paying an interest rate premium (of 34 percent of the interest rate) on taxable bonds, and issuing nontaxable bonds with no premium.

6. Eliminating uncertainty about whether FSLIC bonds are supported by the "full faith and credit" of the U.S. Government would improve FSLIC's ability to finance liquidations with notes rather than cash. This would move FSLIC toward an unconstrained choice between liquidation and assisted acquisition, thereby reducing the likelihood that FSLIC will preserve thrifts with negative franchise value.

Section IV: The FSLIC Acquisition Bidding and Negotiation Process in 1988

1. In keeping with sound economics, both the Merger and Acquisition Division and the Southwest Plan Division expressly attempted to make the bidding process as competitive as possible by attracting a large number of bidders. They were successful in this regard as they received multiple bids for most thrifts marketed in 1988.

2. The assistance packages offered to acquirers include yield maintenance agreements that have features similar to riskless securities, but usually pay higher interest than Treasury Bills. Moreover, the yield maintenance is tax-free, whereas interest on Treasury Bills is not. Since the yield maintenance is terminated when problem assets are sold, there is an incentive to delay those sales.

3. The issues in dealing with problem assets are fundamentally the same, whether assets are sold to an acquirer, or liquidated in a receivership. Differences in the efficiency of these two options for asset disposal must be traceable to differences in incentives. A properly structured incentive contract should permit asset disposals to be handled as efficiently in liquidation as in assisted acquisition.

4. The current forms of assistance packages should be replaced by a "Clean Assistance Package" that would have three key features:

   First, it would be based on contracts with terms that are fixed across all bidders, where the only point of negotiation is the amount of the note (or cash) required from FSLIC. In addition, the package would exclude special forbearances, branching rights, and warrants. Such an approach would avoid the need for complex bid evaluations, and would eliminate the possibility of rejecting what is actually the least-cost bid.

   Second, it would require that acquirors rebate 100 percent of tax benefits to FSLIC. This would avoid tax-induced distortions in the bidding process, and would mitigate some of the incentive problems in current assistance agreements.

   Third, it would limit the use of terms that create incentives to delay the disposition of problem assets.

5. FSLIC should consider "stripping" problem assets from troubled thrifts for separate treatment. By handling problem assets in this way, the fundamental incentive problems would be no worse than under assisted acquisition, and yet some economies of scale may be achievable.

6. FSLIC should be open to a wide range of approaches to liquidation. Alternatives to the standard receivership contract that utilize incentives for prudent asset disposition may represent the most efficient solutions.

Section V: Analysis of the FSLIC Methodology for Evaluating Bids

1. Current FSLIC methodology for estimating the cost of assisted acquisition and the cost of liquidation produces estimates subject to considerable error. As a result, FSLIC can make only imprecise comparisons when choosing between liquidation and assisted acquisition as resolution mechanisms. In addition, FSLIC can make only imprecise comparisons of alternative bids for the same thrift(s).

2. Our analysis suggests that the costs borne by the government in assisted acquisitions may be substantially higher than that estimated by FSLIC.

3. After accounting for several adjustments to the FSLIC methodology, the costs of 24 of 84 assisted acquisitions that occurred during 1988 rise to a level that exceeds FSLIC's estimated cost of liquidation. (These 24 cases account for 30 percent of total estimated costs of liquidation for 1988.) The analysis suggests that (i) the differences between estimated costs of acquisition and liquidation are highly sensitive to even small changes in the former, and (ii) liquidation may have been a viable alternative to assisted acquisition in a significant number of cases.

4. A series of adjustments to the cost estimates used in the largest deal of 1988, the acquisition of American Savings and Loan by the Robert Bass Group, raises the estimated cost of assisted acquisition to the consolidated government by $1.6 billion, relative to the estimated cost of liquidation. This does not necessarily indicate that it would in fact have been less costly to liquidate the thrift, since the cost of liquidation is difficult to assess for a thrift as big as American. However, it does illustrate that the estimates used by FSLIC to compare bids, measure the cost of resolution, and project future costs of resolution are imprecise and probably understated.

5. Considerable progress could be expected from further study of ways to upgrade FSLIC's methods of estimating the cost of acquisition and cost of liquidation. Estimates of the cost of liquidation require particular attention.

6. Several of the features of the current assistance package (special forbearances, branching rights, warrants, etc.) are particularly difficult to evaluate, and in some cases FSLIC makes no attempt to do so. Eliminating these features, as suggested in our "clean assistance package" would improve comparisions across bids and liquidation.

7. Given that the costs of acquisition may be higher than originally estimated, FSLIC should closely scrutinize the liquidation alternative. It is important to estimate the cost of liquidation as accurately as possible, and to ensure that the most efficient means of liquidation have been entertained.

8. To assess the accuracy of estimates used in resolution decisions, and to monitor acquisitions consummated in prior years, FSLIC should maintain an ongoing research program. The program would compare original cost estimates with actual results, and identify problems in the execution of the assistance programs.

Section VI: Empirical Evidence on FSLIC's Cost of Solution

1. There has been considerable public controversy and speculation surrounding several aspects of FSLIC's 1988 assisted acquisitions. In particular, some have questioned (i) whether solutions were less cost-effective in the "December deals" and the "Texas deals" that were part of the Southwest plan, and (ii) what role tax benefits played in the pricing of assisted acquisitions.

2. Preliminary econometric analysis suggests that the December deals and the Texas deals were on average no more or less cost-effective than other assisted acquisitions in 1988. However, a larger fraction of the variance in the cost of the acquisitions remains unexplained in the December and Texas deals.

3. Although our analysis indicates that the "December rush" did not increase average costs of solution as compared to non-December deals, it should be noted that from a consolidated government perspective, there is no reason to accelerate acquisition activity to take advantage of soon-to-expire tax benefits.

4. Our analysis suggests that in the bulk of cases, FSLIC was not compensated for tax benefits that were transferred to acquirers. However, there is evidence of some (less than full) compensation received in the one deal that granted the largest tax benefits to the acquirer (the Utley-Ford transaction).

5. Our analysis suggests that FSLIC did trade off higher assistance payments to receive "rebates" of future tax benefits. However, rebates of tax benefits to FSLIC provide no benefit to the consolidated government. Therefore, any such tradeoffs would indicate an increase in the cost of assisted acquisition.

6. Since the preliminary analysis suggests that FSLIC was not fully compensated for tax benefits granted to acquirers, it raises the possibility that the bidding process was not fully effective.

7. Further research should be conducted (a) to evaluate more fully the effectiveness of competition among bidders, (b) to assess the role played by forbearances and other negotiated provisions, and (c) to examine which characteristics of troubled thrifts cause high costs of assisted acquisition.

I. INTRODUCTION AND OVERVIEW

A. BACKGROUND

During the course of 1988, the Federal Home Loan Bank Board (FHLBB) and Federal Savings and Loan Insurance Corporation (FSLIC) used a combination of liquidations and assisted acquisitions to resolve the insurance liability owed to the depositors at a total of 205 insolvent thrifts. According to FSLIC, the cost of FSLIC assistance required in these resolutions was approximately $32.5 billion. The level of resolution activity in 1988 dwarfs that in prior years. (The average number of resolutions per year for the period 1980-1987 was 36, with a high of 47 in 1987.) Even so, the FSLIC caseload of insolvent thrifts still numbers over 200 institutions, with an even greater number of "troubled" or "failing" thrifts that may work their way onto FSLIC's dockets.

Early in 1988, in response to the mounting caseload, the FHLBB and FSLIC (i) developed the so-called Southwest plan aimed at using assisted acquisitions to resolve insolvent Texas S&Ls, (ii) broadened their on-going programs for managing insolvent thrifts, (iii) introduced new techniques for marketing insolvent S&Ls, and (iv) changed the characteristics of many of their assisted acquisitions. In December 1988 the FHLBB and FSLIC completed negotiations on 34 assisted acquisitions involving 75 thrifts, apparently to avoid a 50% reduction as of December 31, 1988 in the value of tax benefits associated with certain types of FSLIC assistance to acquirers.

In Table I-1 we present some basic data concerning the 1988 resolutions through assisted acquisition. The "cost of solution" through assisted acquisition (COS), calculated by FSLIC, is a measure of the present value of its assistance to the acquirer. For the full set of 1988 deals, COS averaged $340 million, but was higher for the December deals and for Southwest plan deals. This pattern reflects differences in the net worth deficits, i.e., the "size of the holes", in the Southwest and December deals.

The dollar values of tax breaks to acquirers are not included in the FSLIC's estimates of COS. Table I-1's breakdown of deals indicates that (i) the average tax benefits to acquirers in the December deals ($69 million) is more than eight times that of non-December deals, and (ii) the tax benefits in Southwest deals are even higher on average ($115 million). For the subset of Southwest deals consummated in December, the average is $227 million.

Table I-2 presents further data for the ten largest deals in terms of COS. The data include the cost of FSLIC assistance to the acquirer and the dollar value of tax benefits to the acquirer. When these costs are expressed as fractions of the cost of liquidation, the data reveal that the sum of FSLIC assistance and the tax benefits is close to the cost of liquidation in some cases. This suggests that FSLIC faced difficult decisions in deciding which resolution alternative to choose.

During 1988 the FHLBB and FSLIC operated under tight personnel and dollar resource constraints. The personnel constraints probably FSLIC's expansion of its programs to manage insolvent thrifts. The constraint on borrowing authority (the FHLBB was authorized by Congress to raise a total of $10.8 billion over the period 1987 to 1989) probably limited the number of insolvent cases that could be liquidated. Hence, these constraints may have led to a higher level of acquisitions in 1988 than would otherwise have been desirable.

How the level and cost of 1988 resolution activity will compare to future years is not certain, in part because estimates of the dollar value of the current shortfall in S&L assets are imprecise. It is relevant to note that FSLIC insures deposits worth (as of September 1988) approximately $1.3

TABLE I-1

TOTAL AND AVERAGE VALUES OF COST OF SOLUTION,
TANGIBLE NET WORTH AND TAX BENEFITS ACCRUING TO ACQUIRER:
FOR 1988 FHLBB ASSISTED ACQUISITIONS
Millions of Dollars

	Number of Deals	Cost of Solution		Tangible Net Worth[a]		Tax Benefits to Acquirers	
		Total	Average	Total	Average	Total	Average
TOTAL	86	29907	348	19006	226	2771	32
December	34	18184	535	10206	319	2337	69
Rest of Year	52	11723	225	8800	169	434	8
Southwest Plan	16	18989	1187	10736	267	1840	115
Other Deals	70	10918	136	8270	118	931	73

NOTE:

[a] Based on a sub-sample of 84 deals; data for two Southwest Plan deals are incomplete.

SOURCE: FHLBB data on 1988 case resolutions.

TABLE I-2

10 HIGHEST 1988 FSLIC RESOLUTIONS
RANKED BY ESTIMATED PRESENT VALUE OF COST OF SOLUTION
Millions of Dollars

		Present Value of Cost of Solution		Present Value of Tax Benefits to Acquirer		
FSLIC Case #	Name of Acquirer	Total Amount (millions)	As % of Cost of Liquidation	Total Amount (millions)	As % of Cost of Liquidation	Tangible Net Worth (millions)
21	UTLEY FORD[a,b]	5350	78.4	1127	16.5	-1592
378	BASS[a]	2355	70.7	219	6.6	-1336
383	1ST NATIONWIDE[a]	2161	88.9	173	7.1	-831
2	SOUTHWEST[b]	2115	84.5	2	0.1	-1076
20	CFS[a,b]	1846	87.2	217	10.3	-1469
15	GUARANTY[b]	1489	68.6	92	4.3	-1294
25	HYPERION PTR.[a,b]	1372	92.0	18	1.2	-513
17	MUOLNEY[b]	1321	79.2	32	1.9	-755
6	AMERICAN FED BANK[b]	1314	86.5	1	0.1	-1062
393	MICHIGAN NATIONAL[a]	1105	93.6	85	7.2	-1001

NOTES:

[a] Denotes a December 1988 acquisition agreement.
[b] Denotes a Southwest Plan acquisition agreement.

trillion at the over 3,000 savings and loan institutions. During the early part of 1988, most estimates of resolution costs were in the range of $20 to $40 billion, the lower value of which was not not far beyond the level of FSLIC's resources. It is clear, however, that FSLIC resources are far less than their current obligations. The General Accounting Office, for example, estimates the cost of resolution over the next ten years to be in the range of $80 billion. Some who early in 1988 argued that $40 billion was a minimum level of FSLIC exposure now warn that the ultimate exposure could be in excess of $120 billion.

B. CAUSES OF THE INSOLVENCY CRISIS

Several types of economic "shocks" are often identified as proximate causes of the large scale of S&L insolvencies, with the collapse of real estate markets in the Southwest and sharp changes in short and long term interest rates during the 1970s and 1980s most prominently cited. Additionally, although the extent of the problem is not known, fraud appears to have contributed to the problem. These factors are worthy of review, and no doubt they triggered many insolvencies and contributed substantially to the size of the problem. However, a flawed regulatory framework designed around a mispriced FSLIC insurance contract is probably the underlying cause of the large scale insolvencies resulting from economic shocks. In support of this view, while insolvencies in Texas account for a disproportionately high share of the total, the geographic dispersion of failing and insolvent S&Ls is widespread despite substantial growth in many sectors of the U.S. economy during the 1980s.

A key fault with the insurance system was that FSLIC charged all S&Ls (regardless of their riskiness) a flat premium calculated as a percent of insured deposits. Because insurance costs did not reflect differences in risk among institutions, thrifts did not have to pay at the margin for the risks they incurred. They could therefore issue deposits at essentially risk free rates and invest these in risky ventures without fully paying the cost of this risk. Moreover, the contract did not include many other devices that insurers commonly use to prevent excessive risk taking such as strict monitoring of insured behavior, deductibles, and effective limits on insurance coverage.

This incentive toward risk taking inherent in the structure of deposit insurance can be related to advances in finance theory. The FSLIC insurance contract is correctly viewed a put option, sold by the government to S&L's at rates unrelated to the risk of the underlying assets and liabilities. The contract requires the government to pay out assistance if the asset base of a savings and loan falls below a certain level.

The value of this put option increases with the riskiness of the underlying assets, thus establishing an incentive for S&Ls to take on risk. Further, according to theory, the incentive is especially strong when an S&L's asset base falls to close to the threshold level. Whether the incentive exists for all S&LS and is in fact stronger for weakened S&Ls may depend on whether a thrift is organized as a stock or mutual company. The theory clearly applies to stock S&Ls, but may not to mutuals. Where it does apply, it is the interest of rational savings and loan managers to increase the portfolio risk. The term "rational" bears emphasis in conveying the point that the insurance contract encourages all S&L managers -- not just those not engaged in fraudulent activity -- to add risk to their balance sheets. It is the design of the insurance contract that creates incentives for some S&Ls to acquire risky assets and thereby increase FSLIC liabilities.

One might argue that the structurally induced should be counterbalanced by regulatory discipline in order to prevent or control excessive risk taking. During the early and middle 1980's, however, thrifts were actually subject to fewer regulatory constraints than previously. On the liability side, the Depository Institutions Deregulation and Monetary Control Act of 1980 provided for a phaseout of the interest rate ceiling (Regulation Q) on thrift and commercial bank deposits. The Garn - St Germain Depository Institutions Act of 1982 allowed thrifts to go beyond their traditional asset base of fixed rate mortgages of one to four family dwellings.

Moreover, during the time period 1982-1985, regulators issued numerous forebearances that allowed thrifts to escape from complying with certain rules. The regulators also changed the definition of capital assets, which allowed thrifts to increase their reported net worth and thereby avoid increased regulatory oversight. Neither the FHLBB, FSLIC nor the District Banks drastically increased their monitoring and supervisory oversight of thrifts during these years.

Given the deficiencies of the FSLIC insurance contract and the lack of strict monitoring, the liberalization of thrift regulations in the early 1980s was particularly ill timed. First, the new thrift regulations coincided with an increase in interest rate volatility. Second, the rapid rise in the level of interest rates in the late 1970s and early 1980s (combined with the interest rate sensitivity of traditional thrift portfolios) significantly eroded thrift net worth. It should be noted that these factors suggest that while FSLIC insurance premia might have been actuarially fair before 1980, they were not afterwards. In addition to the legislation allowing thrifts to take on more risk, more volatile interest rates made the FSLIC insurance more valuable.

Thus, the increase in the riskiness of the overall economy and the appearance of incentives to take more risk coincided in 1982 with the evolution of a less restrictive regulatory environment. This conjunction of economic and regulatory events increased the overall riskiness of the thrift industry and increased the exposure of thrifts to economic shocks common in a dynamic economy. The decline in net worth experienced by many S&LS gave managers incentives to take more risk. These low net worth institutions had little of their own capital at stake on the downside, had deposit insurance to cover any losses, and stood to capture fully the upside gains.

While one might not have been able to predict the specific large scale shock that would ultimately give rise to a thrift crisis, the fact that a shock the size of the one that hit the Texas real estate market would cause widespread failure was predictable. It is important to realize that shocks of that magnitude are not extremely rare events. The New York city financial crisis and the collapse of the steel industry are examples of major shocks of similar magnitude in terms of regional impact. The "Texas bust" had a pronounced impact on S&Ls because they were over-exposed to the risks of such an event, not because the event was uncommonly severe. This overexposure was a direct consequence of a flawed regulatory environment.

Two others features of the regulatory framework deserve mention. One, neither the FHLBB nor FSLIC employ bank examiners nor perform audits. Rather these tasks are performed by the twelve FHLBB District Banks, which are wholly owned by the member institutions. A majority of the District Bank's boards of directors are also elected by member institutions. Two, S&Ls operate with either federal or state charters. The state charter thrifts account for a disproportionately high number of the total number of recent insolvencies, suggesting either there exists some uncertainty about where ultimate regulatory authority lies or that asset management rules in some states may be relatively weak.

In these regards it is noteworthy that while insolvencies have occurred among commercial banks, problems in that sector of the financial services industry seem to be less severe. This difference may be due in part to the substantial resources employed by the FDIC to monitor all commercial banks. Recently, the monitoring has been strengthened. In particular, the FHLBB has taken steps to control direct equity investments, has reformed accounting practices, and has doubled the number of examiners at the district bank level. Moreover, to improve the pricing of deposit insurance the FHLBB in 1985 increased the FSLIC insurance rate by 1/8 of 1 percent from the base level of 1/12 of 1 percent. It did not, however, introduce risk based pricing or risk based reserve requirements. (The latter is currently under FHLBB consideration.)

In sum, one should not attribute the current spate of insolvencies to economic factors outside human control. Given the incentives inherent in the system, significant numbers of failures were inevitable. The only question was where and when these failures would occur. Moreover, unless the underlying problems with the pricing of deposit insurance are dealt with as part of the solution to the current crisis, there will undoubtedly be future shocks that create such crises anew.

C. KEY ISSUES AND THE STRUCTURE OF THIS REPORT

The focus of this report is on insolvency resolution in 1988 and what can be learned from that experience to help guide efforts to resolve the remaining insolvencies quickly and efficiently. We take the view that the FHLBB policies and their implementation during 1988 should be evaluated, not just in

terms of FHLBB or FSLIC costs, but in terms of their full impact the U.S. government's liabilities from the current and future S&L insolvencies, including their impact on tax revenues. We call this perspective the "consolidated" approach.

We are aware that a perspective focused more narrowly on FSLIC costs might be supported by the fact that Congress authorized the FHLBB to use tax free forms of assistance in acquisitions. This action could reflect Congressional intent to preserve the thrift industry, even if one effect was to increase overall government liabilities. Also a broader perspective might be appropriate if for example state governments are affected by resolution activities. Nonetheless, it is natural to inquire whether the 1988 agreements were designed to reduce U.S. government liabilities. Similarly, it is important to understand for the set of deals with significant tax benefits accruing to acquirers how the reductions in the FSLIC costs compare to the losses in tax revenues.

Questions of this type are complex and interrelated, but an inquiry into the key issues can be organized around the various stages of the insolvency resolution process. The first stage of the process is the identification of insolvent institutions, which is done at the District Bank level. Here the issues relate to monitoring activity by examiners and outside auditors, information acquisition, and the criteria for categorizing a thrift as insolvent at which time it is passed on to FSLIC. As we discuss in Section II, the failure to identify insolvencies in a timely manner can increase the magnitude of the problem dramatically.

The second stage of the resolution process is what might be termed the "holding pattern" at FSLIC. While a case awaits evaluation and processing for disposition either through liquidation or assisted acquisition, FSLIC faces the issue of how to control the growth of its exposure. Again, questions of information acquisition and monitoring arise, as well as how to structure interim management of the thrift. Most holding pattern thrifts will incur operating losses that must be covered either by generating new deposits, by selling off remaining marketable assets or by FSLIC cash infusions. The proper selection of cases for resolution (versus deferring resolution) depends on the rate of growth of the liabilities associated with an insolvent institution under FSLIC control. These issue are addressed in Section II of the report.

Once into the holding pattern, the process of deciding on whether the ultimate resolution should be liquidation or assisted acquisition begins. In assessing the choice between the assisted acquisitions and liquidations, a key issue is whether there exists "franchise" value associated with the institution's ongoing operations that can be preserved through assisted acquisitions. Recognition and identification of the sources of franchise value is therefore fundamental to understanding the choices between liquidation and assisted acquisition. We address these issues in Section III of the report.

For those cases selected for assisted acquisitions, FSLIC must set up an efficient and competitive bidding and negotiation process to minimize the costs of various forms of assistance. In this regard, the terms of the assistance agreement and their ramifications for that process are an important consideration. The FSLIC terms involve considerable complexity. In addition to cash and notes, agreements usually involve yield maintenance, and capital loss coverage, and often involve tax benefits, regulatory forebearances, and warrants. Although these provisions reduce the risk to acquirers, they also create complicated incentive problems that can affect FSLIC's exposure from the contract as well as their ability to value that exposure accurately. Such issues raise questions concerning contract design and the benefits from using simple assistance agreements. These questions are dealt with in Section IV of the report.

In making the choice between the liquidation and assisted acquisition alternatives FSLIC develops cost estimates for liquidation and for each proposed bid package. Accurate evaluation of the costs of these alternatives is fundamental to lowering the overall costs of solution and for gauging FSLIC's total exposure. In Section V, we analyze FSLIC's evaluation methods and offer several adjustments that should increase their accuracy. We then show how accounting for some of these adjustments could have altered the choice between liquidation and assisted acquisition in the 1988 deals. We also take a specific look at one important transaction to exhibit how the adjustments may be made.

Certain controversial questions have been part of the policy debate concerning the 1988 assisted acquisitions. One prominent issue is whether the deals consummated in December were cost-effective from the "consolidated" government perspective as opposed to the top power agency perspective. Another concerns the cost-effectiveness of the Southwest Plan deals, in which several thrifts were generally consolidated into larger packages and in which a separate negotiating authority was involved. In Section VI, we undertake an empirical study designed to address these questions. We also identify other questions that could be answered with further research.

The final Section of the report offers a brief set of conclusions, and recommendations for an ongoing research program aimed at improving the information base upon which insolvency resolution takes place.

II. THE TIMELINESS OF REGULATORY ACTION
AND THE GROWING NET WORTH DEFICIT

A. INTRODUCTION

FSLIC's exposure to deposit insurance claims (reflected in the aggregate net worth deficit) has increased over time due to a myriad of factors. However, inasmuch as FSLIC's exposure reflects poor S&L investment decisions in the past, the net worth deficit represents a problem that cannot be undone by FSLIC or the FHLBB. Moreover, a portion of the continuing growth in the net worth deficit simply reflects the fact that, for insolvent thrifts, past actions have resulted in more liabilities than assets. Once liabilities exceed assets, the net deficit (if measured in terms of current market values) will tend to grow at the rate of interest, unless the thrift takes steps that create new economic gains or losses. The potentially controllable problem is losses in excess of that implied by the interest growth in net worth deficit, which arise because thrifts take steps that create additional economic losses. When these losses are occurring, deferring resolution raises FSLIC's costs.

In fact, the net worth deficit has tended to grow more rapidly than the rate of interest. FSLIC estimates that the rate of growth was approximately 12 percent in late 1988. If the net worth deficit were based on market values, this rate would suggest excessive losses at insolvent thrifts. Given that the measured rate is actually based on accounting information that does not fully reflect current market values, it is difficult to interpret. However, until better information is made available, there remains a concern that the rate of growth in the net deficit reflects current actions by thrifts that are causing additional economic losses. Certainly the conventional wisdom is that at least in many cases, failing and insolvent thrifts are adding to their net worth deficit.

While FSLIC can resolve insolvencies through liquidation or assisted acquisitipn, significant time frequently elapses between the recognition of a problem and its resolution. Given that FSLIC is unable to resolve all problem thrifts on its caseload within a short time frame, it faces the problem of assessing and controlling mounting losses prior to resolution. In this section we examine the sources of liability growth in more detail, and analyze FSLIC's efforts to control this growth.

B. THE SOURCES OF GROWTH IN THE NET DEFICIT

Three factors contribute to the deterioration of a thrift's net worth position: (1) the returns from an insolvent thrift's assets and the fees it collects for services may not be sufficient to pay the interest it owes on deposits, (2) the thrift may not be able to cover overhead and operating expenses, and (3) the thrift may belatedly recognize losses on its assets.

The third factor, belated recognition of losses on assets, reflects an economic loss that has already occurred in the past, and does not represent a current increment in the size of the economic problem. Operating losses driven by the first two factors do represent real current economic outflows. The question is whether these outflows will cause net deficits to grow at faster than the interest rate.

There are two possible sources of excessive growth in the net deficit. One is associated with financing decisions, and the other pertains to investment and risk management.

1. The impact on net deficit growth of financing decisions.

The components of operating losses that represent real economic outflows must somehow be financed. The three potential sources of funding to cover these losses are (1) FSLIC cash infusions, (2) additional borrowing, and (3) sales of assets. If FSLIC infuses cash to cover current operating losses, the thrift's net worth deficit will stop growing (in terms of market value), so long as the thrift's managers do nothing to create new economic losses. Thus, this form of financing stops excessive deterioration in net worth. Excessive deterioration in net worth can sometime occur, however, when financing alternatives (2) and (3) are selected.

Borrowing to cover operating losses. Whether borrowing to cover operating losses represents a problem for FSLIC depends on whether the thrift pays an above-market premium on deposits. If no premium is paid, then deficit net worth (in terms of market value) will tend to grow over future periods at the rate of interest. However, in terms of present value, the deficit remains unchanged. Thus, FSLIC should be indifferent between infusing cash, and the thrift borrowing at market rates of interest.

The problem is that many insolvent institutions have in fact resorted to paying premium rates on deposits to finance their on-going interest expenses. The so-called "Texas premium" paid by some thrifts is an example of this phenomenon. If we assume that deposit insurance renders deposits at these thrifts as risk-free as deposits at other thrifts, then those premiums represent above-market rates of return. When operating losses are financed with borrowing at above-market rates, deficit net worth grows at a pace in excess of the interest rate. For that reason, FSLIC would always be better off if losses are covered with cash infusions, rather than borrowing at a premium.

Since it is borrowing at premium rates, rather than borrowing *per se*, that is problematic for FSLIC, excessive growth in the net deficit should be constrained by precluding thrifts from offering above-market rates on

deposits. If FSLIC were provided with sufficient liquidity to make cash infusion a viable option for all insolvent thrifts, then regulations that prevent borrowing at above-market rates could be enforced. In addition to constraining losses at the borrowing thrift, such an action would alleviate difficulties faced by other thrifts who must compete for funds in the same market.

Asset sales. Whether asset sales to cover operating losses are problematic for FSLIC depends on whether the assets are sold for fair value. If they are, then the thrift suffers no economic loss (even though there may be an accounting loss on the sale). Deficit net worth (measured in terms of market value) would tend to grow over future periods at the rate of interest, but the present value of the deficit would remain unaffected. FSLIC should be indifferent between sales of assets at fair value and cash infusions to finance operating losses.

The potential problem is that assets might be sold at "bargain" prices in order to supply much-needed liquidity. When this happens, the thrift suffers an economic loss, and deficit net worth will tend to grow at a rate in excess of the interest rate. FSLIC would be better off to infuse cash, rather than allow this to occur.

It should be recognized that, unless FSLIC supplies cash infusions when troubled thrifts need liquidity, thrift managers have incentives to sell assets at bargain prices. Excessive growth in the net deficit can be constrained by controlling such asset sales.

2. The impact on net deficit growth of investment and risk management

A second source of excessive growth in the net deficit arises because of the incentive structure created by the guaranteed deposit insurance system.

Recall from section I that incentives for thrift owner-managers to bear risk are greatest when thrifts are thinly capitalized. If risk-bearing generates high profits, the owners of the thrift reap those gains. On the other hand, if the risk-bearing generates losses, it is FSLIC that suffers the consequences. Pursuit of risky projects can potentially be optimal for owner-managers, even if the expected payoffs on such projects are negative. In the vernacular of option pricing theory, a troubled thrift is like a call option that is at-the-money or out-of-the-money, and such call options are made more valuable when risk is increased.

Increasing risk makes the thrift more valuable to its owners, but that value arises only because FSLIC bears the risk on the downside, at a price that does not reflect that risk. FSLIC's exposure can be reduced by doing two things. First, managers of troubled thrifts can be closely monitored, to control their desire to undertake risky projects. Second, FSLIC could strip managers of insolvent thrifts of any equity rights. This would eliminate a manager's tendency to behave as if the thrift were a call option, thus removing the incentive to pursue risky projects. A management incentive contract could then be arranged that would cause managers to be concerned not only about the upside potential of investment projects, but also the downside risk.

Clearly, regulatory attention needs to be directed to cases where there is excessive growth in deficit net worth. Persistent declines in the net worth of a subset of thrifts may indicate inefficient management, or a management that attempts to maintain its position without regard to the consequences for FSLIC or other thrifts. In addition, if the operating losses are widespread, they may reflect an oversupply of financial services in the regional market.

Continuing losses in unregulated industries trigger bankruptcy, managerial changes, and the eventual reduction in the number or capacity of active suppliers. These market forces eliminate inefficient resources from an industry. In the thrift industry, regulatory actions serve this function and are therefore required to stem the rate of increase in FSLIC's liability. In this light, the Southwest plan initiated by FSLIC to deal with widespread Texas S&L insolvencies made sense, and evidence suggests that it succeeded in consolidating the industry and reducing the upward pressure on rates paid to depositors.

C. METHODS TO CONTROL THE PRESENT VALUE OF FSLIC LIABILITIES

FSLIC can control the present value of its liabilities by either (i) intervening directly in the management of failing institutions, or (ii) overseeing the transfer of the firm's assets and liabilities to new owners and managers. Regarding the second alternative, FSLIC employs two means of transferring ownership: liquidation and assisted acquisition.

Although it would be desirable to quickly resolve many cases either through liquidation or assisted acquisition, the large number of institutions on its caseload and the constraints on FSLIC resources make it impractical to do so. Effective marketing takes time, as does the consummation of a sale or liquidation. In addition, FSLIC may not possess the cash resources or personnel required to immediately liquidate an insolvent thrift or to negotiate assisted acquisitions for the institutions on its caseload. Thus, in addition to choosing the method of ultimate resolution, FSLIC must make choices regarding which cases have highest priority.

When failing institutions are identified, the Federal Home Loan District Banks and FSLIC intervene directly to control the management with the objective of restricting actions that increase FSLIC's liabilities. When a thrift begins to experience difficulties, the District Bank's Supervisory Agent (SA) will step up his monitoring of the thrift, ascertain its true financial condition and oversee attempts to address the causes of its losses. The institution's managers must obtain SA approval for all major business transactions. At this time, the District Bank, with the assistance of the SA, may also attempt to find an in-state acquirer willing to take over the troubled thrift without financial assistance.

The District Bank will file a request to transfer failing institutions to FSLIC if (i) an in-state merger is impractical, (ii) financial assistance is required, or (iii) the appointment of a receiver is needed due to the degree of insolvency. After verifying that the preconditions for transfer are met, FSLIC's Merger and Acquisition Department (MAD) takes control of the case.

Upon transfer of a thrift, FSLIC oversees the monitoring and disposition of the institution. Even after taking control of a troubled thrift, however, FSLIC depends on continued District Bank cooperation. Neither FSLIC nor FHLBB employs examiners to do audits of institutions under its control. Therefore, FSLIC is dependent on the District Banks to supply vital information concerning the financial condition of the institution and to oversee its operations while FSLIC devises a resolution strategy. The Supervisory Agent continues the direct intervention in the thrift's operations. A variety of consent decrees can be used to constrain management activities, but in most cases direct FSLIC involvement in the thrift's management is limited.

For the subset of cases in which the continuation of the thrift's current management structure is most likely to add significantly to FSLIC's future obligations, e.g., in the case of uncooperative management, FSLIC can intervene directly to take control. Over the past two years, FSLIC developed

and expanded its Management Consignment Program (MCP), whose objective is to install new managers to operate the institution in a way to reduce FSLIC obligations. The installation of new management may involve the appointment of a conservator, putting the institution in receivership, and the creation of a new federal mutual incorporating substantially all the old thrift's assets and liabilities. Alternatively, FSLIC can establish a liquidating receivership and create a new federal mutual incorporating the insured liabilities and assets of the old institution that are not potentially harmful to the new organization.

D. AN ANALYSIS OF REGULATORY OVERSIGHT OF INSOLVENT THRIFTS.

FSLIC recognizes the necessity of expedited processing of cases and of controlling thrift losses prior to resolution. However, the instruments at the Corporation's command -- particularly prior to the transfer of a case -- appear to be inadequate to take the decisive action required to stem the growth of the net worth deficit. Furthermore, although Bank Board regulators have exerted increased control over institutions experiencing financial difficulty in an effort to minimize the insurance fund's exposure to deteriorating net worth, it is unclear whether these efforts are sufficiently vigorous or rapid in light of the rate at which losses frequently mount. Thus the lack of adequate remedies and the lack of resources to carry out existing policies appear to have caused losses have continued to mount for too long, thus increasing the insurance burden.

Part of the difficulty with case resolution lies with inadequate monitoring by District Banks, with the result that some failed thrifts continue to post excessive losses for several years before District Banks transfer authority to FSLIC. This delay tends to increase the present value of FSLIC's obligation.

More immediate actions to control the management of troubled institutions would reduce the costs of the insurance obligation. It would be desirable to empower FSLIC, the Bank Board or District Banks to intervene to correct problems at an institution on the verge of insolvency, in order to prevent excessive net worth deficit growth. As noted in Section I, the thrift's incentives to take risk (and thereby raise the expected value of FSLIC's obligation) are most acute when a bank is thinly capitalized. FSLIC or the District Banks could make a substantial contribution to the limitation of insurance costs by intervening forcefully to exert control over a thrift on the verge of insolvency. In this regard, FSLIC's current review of an Early Intervention proposal (whereby FSLIC could appoint a conservator or receiver before insolvency occurs) is entirely appropriate.

Whatever criteria are used to declare a thrift insolvent or nearly insolvent, they should be established, pre-announced, observable criteria that are then administered in a timely and precise manner. If a firm violates these criteria, FSLIC should seize control immediately (with some grace period, say two weeks, for the owners to present new information, in case an error has been made). As suggested above, upon taking control, FSLIC should extinguish all equity rights of current owners. FSLIC itself should then be the residual claimant to not only future losses, but also future gains.

Of course, earlier intervention requires accurate information about the financial conditions of failing institutions. Indecisive action and delay in transferring supervision to FSLIC is in part symptomatic of organizational and/or agency problems between FSLIC and the District Banks. While FSLIC is directly responsible to depositors, it has limited ability to intervene when potential problems arise. The fact that member institutions own District Banks and elect their directors may exacerbate this problem. Although a "Chinese wall" separates examiners from managers in District Banks this division of interest and responsibility may still affect the incentives to aggressively address emerging problems.

Unfortunately, the information provided by the District Bank when a case is transferred frequently does not completely reveal the extent of the thrift's problems. When a District Bank considers transfer of an institution to FSLIC, the regional examiners commonly expand only enough effort to determine whether an institution is "comfortably net negative." That is, instead of conducting an exhaustive audit to determine the exact magnitude of an insolvency, they only determine whether the insolvency is larger than some threshold. Subsequent to the transfer further analysis routinely reveals more severe problems.

In prioritizing cases, FSLIC has correctly focused on the growth of an institution's negative net worth while recognizing the difficulties in inferring the true growth rate. When updated accounting information becomes available, the substantial growth rates reflected in these data include both the revelation of pre-existing shortfalls as well as continuing losses. This makes extrapolations concerning future liabilities particularly difficult. The methodology FSLIC has developed to evaluate available information regarding the assignment of cases to MCP is conceptually correct and should be more systematically applied. To date, FSLIC has not made a systematic attempt to monitor the growth of net deficit worth in a way that permits an assessment of the reasons for the growth. We recommend that such an attempt be made, in order to help forecast the future size of "the hole," as well as to identify troubled thrifts more quickly.

A good system for detecting troubled thrifts at an early stage would include periodic mark-to-market accounting. In the absence of such a system, a thrift with deficit net worth in an economic sense can appear to be well-capitalized according to accounting records for extended periods. Another difficulty is that, in the absence of a market-value-based accounting system, it is extremely difficult to interpret reported growth rates in deficit net worth. Thus, there is uncertainty about whether that growth is "excessive." The difficulty of estimating market values is no excuse for ignoring them in the accounting system.

Once thrifts have been identified as problem cases, FSLIC and FHLBB should also move to directly control the deposit rates offered by the set of insolvent institutions. The desperate attempt to remain liquid by attracting deposits, as indicated above, forces other thrifts to raise rates. Limiting the interest that failed thrifts can pay depositors would thus reduce the strain on the entire thrift system. However, limiting deposit rates would require FSLIC to provide liquidity to troubled thrifts in order to allow them to pay interest and withdrawals on existing deposits.

The FSLIC is to be commended for instituting the Management Consignment Program. That program may serve as a model for regulatory efforts to prevent mushrooming losses at financial institutions. However, we do not suggest that outside management control is always appropriate. The new managers assigned to a thrift in the Management Consignment Program are essentially caretakers. It is unclear whether they have the proper incentives to maximize the value of the thrift they manage and whether they have the authority to take the sometimes severe steps required to limit FSLIC obligations, e.g. lowering deposit rates and restricting the sale of higher quality assets.

In summary, constraints faced by FSLIC have made resolution more costly in at least two ways. First, FSLIC does not have the resources to implement the Management Consignment Program as widely as would be desired. Secondly,

cash constraints at FSLIC prevent free use of cash infusions to cover operating losses at insolvent thrifts. The result is exacerbation in the net deficit because of borrowing at above-market rates or selling assets at bargain prices.

III. RESOLUTION OF INSOLVENT THRIFTS: FUNDAMENTAL ISSUES

A central question is how should FSLIC utilize its primary resolution alternatives -- liquidation or assisted acquisition -- to minimize its exposure to insurance liabilities. Regardless of which alternative it pursues, FSLIC must provide financial assistance to induce others to assume deposit liabilities. Should FSLIC liquidate all insolvent thrifts? If only some, which ones?

A. DESIRABLE CHARACTERISTICS OF A RESOLUTION PROCESS

The ideal resolution process would (1) identify any existing "franchise value" possessed by troubled thrifts, (2) allow FSLIC to receive full compensation for that franchise value through a competitive bidding process, and (3) be free of constraints that affect the choice between liquidation and assisted acquisition.

1. Preservation of franchise value

When the choice of liquidation versus acquisition is not constrained due to the availability of cash reserves, the optimal resolution action depends fundamentally on the value of troubled thrifts as going concerns. Their insolvency is the consequence of past decisions and events: bad investments, adverse economic developments, mismanagement or excessive risk taking. What is relevant in determining their current value is whether there exists any prospective profitability, once this historical legacy has been resolved.

The value of a thrift as a going concern is called franchise value. The first component of this value derives from marketing advantages in competing for depositors, due to the convenience of the thrift's location or the fact

that current depositors find it more convenient to roll over deposits rather than open an account at a different institution. The second component derives from a thrift's particular value to borrowers due to their location or local market knowledge. These advantages permit a thrift to issue deposits and loans at favorable rates and earn fees for services provided.

Whether any franchise value remains for currently troubled thrifts is a difficult question. The failure of those thrifts may reflect, among other things, an absence of any marketing advantages. Given that other financial institutions (e.g. mortgage banks, money market funds and traditional banks) can now provide most of the same services available from a thrift, it is possible that franchise value has been dissipated for at least a portion of the thrift industry. Moreover, thrifts that are currently insolvent, especially in regions where the economy has been strong, are most likely to be those which have little or no franchise value.

If an insolvent thrift possesses any franchise value, the cost of resolution can be reduced by preserving that value. While an assisted acquisition can potentially maintain franchise value, liquidation destroys the component of franchise value pertaining to dealings with borrowers. Franchise value pertaining to depositors may also be destroyed in liquidation, to the extent that deposits of the liquidated thrift cannot be transferred to and controlled by another depository institution.

Assisted acquisitions not only allow preservation of franchise value, but allow FSLIC to capture some of that value in the form of smaller payments to acquirers to induce them to assume the obligations of an insolvent thrift. Moreover, since franchise value represents the economic worth of a thrift to the consumers of financial services, it is desirable to preserve it when it exists. FSLIC must decide, therefore, which thrifts to terminate (and transfer deposits) and which thrifts to perpetuate because of their value as on-going institutions. Through these actions FSLIC has the power to efficiently restructure the S&L industry and thereby lower its liability costs.

Such restructuring decisions require precise knowledge of the value of thrift resources. This knowledge is difficult to obtain because franchise value is essentially intangible and dependent on who runs a thrift and how. Consequently, different potential acquirers of deposits or entire thrifts may estimate it differently. One process that allows potential acquirers to obtain this franchise value is competitive bidding. The bids submitted in this system incorporate the potential acquirers' willingness to pay for franchise value that they can realize (along with the value of any other benefits offered by FSLIC).

2. An effective competitive bidding process

If bidding for troubled thrifts is fully competitive, the bids will reflect any existing franchise value. Consider an insolvent thrift with a net worth of -100 that possesses a franchise value of 5 to a given potential acquirer. This acquirer would be willing to accept 95 in FSLIC assistance to assume this thrift's negative net worth. By submitting a bid to FSLIC of 95 this acquirer would reveal his willingness to pay. Thus, even if franchise value is difficult for FSLIC to measure directly, a bidding process would reveal whether it exists and what market participants believe it to be worth.

An ideal bidding process would have the following characteristics:

1) It would include large numbers of potential buyers. Potential acquirers are more likely to submit fully valued bids (i.e., bids that contain their full estimate of franchise value) when they expect underpriced bids to fail. Moreover, expanding the number of potential acquirers increases the likelihood of transferring the thrift to the bidder that can realize the largest franchise value.

2) Bidder's offers would not be distorted by the value of tax benefits granted by FSLIC to acquirers. When such benefits are excluded, the bidding process tends to place the thrifts in the hands of the acquirer who can maximize franchise value.

3) FSLIC would be able to identify which is the highest bid. The highest bid represents the least-cost solution to insolvency from the government's perspective.

3. Unconstrained choice between liquidation and assisted acquisition

Ideally, the resolution decision would be free of constraints that would favor either liquidation or assisted acquisition. However, during 1988 the lack of cash reserves and inefficiencies in the disposal of assets under receivership may have made it difficult for FSLIC to pursue the liquidation alternative as frequently as desired.

Lack of liquidity and difficulties in using notes in liquidations. Assisted acquisitions can typically be arranged with little or no cash infusion from FSLIC. On the other hand, cash is necessary during a liquidation, either to retire deposits immediately, or to pay another institution to accept responsibility for the deposits. Given the cash constraints faced by FSLIC during 1988, liquidations may have been difficult to undertake frequently. (The liquidation option was used for 26 of the 205 thrifts involved in 1988 resolution activity.)

Even when faced with a cash constraint, FSLIC could freely pursue the liquidation option if deposits could be transferred to another institution in exchange for a note in much the same way as FSLIC uses notes during an assisted acquisition. FSLIC personnel indicate, however, that in some situations institutions have been unwilling to accept deposits on that basis except at relatively high interest rates. If uncertainties could be eliminated about whether FSLIC notes are backed by the "full faith and credit" of the U.S. Government, this difficulty could be resolved. Moreover, it is somewhat uncertain whether the notes issued in a liquidation are any costlier than the notes (and yield maintenance) offered in acquisitions, given that the former are taxable while the latter assistance is frequently tax free.

Inefficiencies in asset disposal under a receivership. FSLIC personnel have indicated that asset disposal under receiverships has not been as efficient as it should be, and that asset disposal might be more efficiently managed in an assisted acquisition. In principle, however, the difficulties of disposing of problem assets are no different in liquidation than in assisted acquisition. Inefficiencies in managing and disposing of problem assets could be minimized by (1) considering what would be optimal among a wide range of incentive contracts for asset disposal, and (2) remaining open to a range of possible "liquidators," rather than traditional receiverships. It is possible that asset disposal under liquidation would be similar to that under assisted acquisition, but without all the tax-related incentive problems (to be discussed in Section IV) that arise in assisted acquisitions as they are structured currently.

B. RESOLUTION UNDER RESOURCE CONSTRAINTS

If liquidity problems or concerns about inefficient receiverships often preclude the option to liquidate, then FSLIC must determine whether deferred resolution (via future liquidation or merger) is less costly than immediate

resolution through assisted acquisition. Depending on the cost of keeping thrifts in the "holding pattern," it may be optimal to preserve thrifts with negative franchise value. FSLIC's task then becomes a constrained optimization problem; it must strive to minimize costs, given that worthless thrifts cannot be liquidated.

The existence of these constraints, however, do not eliminate the necessity of carefully estimating the cost of both liquidation and acquisition. Only then is it possible to determine (i) which is the least-cost bid, from the government's perspective, (ii) how many thrifts to liquidate, given the current funding constraint, the expected future funding constraint, and the cost of keeping thrifts in the holding pattern, and (iii) which thrifts to liquidate and which to sell given the funding constraint and the outstanding offers. Moreover, a fully informed discussion of the costs of various funding policies requires a clear understanding of the costs of the relevant resolution alternatives.

C. RESOLUTION WITH AN INEFFECTIVE BIDDING PROCESS

FSLIC has in fact utilized a bidding system in order to create a market for its insolvent thrifts. Our assessment is that FSLIC has been fairly successful in making that market competitive. That is, there is a large number of bidders involved.

There are two potential impediments to the effectiveness of the bidding process. First, in most cases, tax benefits are included in the assistance package. As a consequence, FSLIC runs the risk of placing the thrift in the hands of the bidder who can maximize the value of the tax benefits, as opposed to maximizing franchise value.

Second, under the current arrangement, it is also difficult for FSLIC to evaluate bids. (This problem will be discussed at length in Section V.) Improper evaluation of terms contained in the bids can lead FSLIC to accept more costly bids, to sell a thrift that should be liquidated, or to liquidate one that should be sold. A valuation error can lead FSLIC to perceive franchise value where none exits, or vice versa.

In the remainder of this report we describe and analyze FSLIC's Resolution methodology and the application of this methodology in 1988. In Section IV below we describe the competitive bidding and negotiation process used by FSLIC. The methods used to evaluate the bids and to compare them with the option to liquidate are evaluated in Section V. Empirical analysis of the results of the 1988 resolution process are then presented in Section VI.

IV. THE FSLIC ACQUISITION, BIDDING, AND NEGOTIATION PROCESS IN 1988

A. A DESCRIPTION OF THE PROCESS

FSLIC employed two separate marketing channels for large thrifts in 1988. First, it continued to utilize its Merger and Acquisition Division (MAD) to market insolvent thrifts larger than $100 million in size. Second, it devised the Southwest Plan in order to market insolvent S&Ls in Texas. Operationally the Southwest Plan was largely independent of the MAD resolution activity.

The Merger and Acquisition Division, with the assistance of the Analysis and Evaluation Division (AED), developed a priority system to determine which cases should be marketed. Their key criteria were whether the thrifts would be likely to attract bidders and the rate of growth in negative net worth. For these thrifts selected for possible assisted acquisitions, AED developed initial balance sheets based on information extracted from quarterly reports.

Using this often crude information, AED did initial estimates of the cost of liquidation that embodied standard assumptions about the rate at which various types of assets, e.g., one to four family housing units, will be sold. The initial runs also relied heavily on the use of default values, e.g., AED assumed that the market value of most assets is 70% of book value, independent of whether, for example, the asset had already been marked down by 10% or 20%. In general the cost of liquidation analyses suffer from lack of quality information, which can be traced back to the sometimes incomplete information about failed thrifts that District Banks provide to FSLIC. Originally, FSLIC staff at local offices in Texas were to estimate the cost of liquidation for thrifts marketed through the Southwest Plan. However, most Southwest analyses were also done by AED staff in Washington D.C.

Throughout the bidding and negotiating processes, AED assisted MAD and the Southwest Plan management team by updating the cost of liquidation to evaluate how the estimated cost of various bids compared to the liquidation alternative. The quality of information used by AED in most liquidation cost analyses, however, improved only marginally. For example, during the course of negotiations, AED might learn that a particular asset is under contract. The exception to this general statement is that for those institutions in the Management Consignment Program, AED often received much better information. But in general the quality of information used to estimate the cost of liquidation was poor. This point should be borne in mind in later discussions of the methodologies used to compare the cost of liquidations and the cost of assisted acquisitions.

For these insolvent thrifts selected for acquisitions, marketing plans were developed. Using whatever information that could be obtained with the help of the District Banks and the most recent information from outside audits, these plans attempted to incorporate various factors affecting franchise value, including the thrift's branch structure, operations, and market position. The marketing plan also included an analysis of asset problems, the size of the net worth deficit, any tax benefits associated with the thrift, and the thrift's contingent liabilities. MAD and the Southwest Plan managers used this information to compile marketing packages.

MAD and the Southwest Plan managers utilized a variety of means to attract potential bidders. These included direct mailings, telephone solicitation, and (for very large thrifts) a marketing conference. Often attempts were made to identify in-state acquirers. Potential bidders were also identified from a national marketing list that included bank holding companies, FDIC-insured state banks, other S&Ls, national banks, corporate and

private investors, and attorneys and consultants representing potential acquirers.

Once MAD and the Southwest plan managers received bids, attempts were made to clarify any ambiguities with bids; then the costs associated with the bid proposals were estimated. In some cases all bidders were notified that no bid was acceptable. In most cases some bidders were selected for further negotiation. At that point, several FSLIC departments became involved. AED analyzed the cost of various proposals and revisions in proposals, while the Office of Regulatory Approval evaluated requests for regulatory forebearances. A so-called "viability" analysis helped government negotiators determine the financial health of potential acquirers and thus was a key element in attempting to reduce the probability that assisted acquisitions would return to FSLIC as insolvencies at some later date.

Those negotiations culminating in the drafting of a proposed assistance agreement were sent to the Bank Board for approval. The acquisition proceeded upon receipt of Board acceptance. The approved deals typically included (i) "prenuptial" clauses that would require the acquirer to add further capital if the new thrift's net worth fell below a certain threshold, and (ii) enhanced programs for stricter monitoring.

The processes described above can be very time consuming and the negotiations themselves involved several iterations. In some cases FSLIC decided to enter into exclusive negotiations to complete an agreement. FSLIC also sought to expedite negotiations by various means, including giving bidders "take it or leave it offers." The Southwest plan introduced a major innovation by combining independent thrifts into packages that were then marketed and negotiated by teams specializing in the resolution of Texas insolvencies.

B. THE TERMS OF ASSISTANCE AGREEMENTS

The primary features of assistance agreements used in 1988 were: (1) the provision of cash assistance or a FSLIC note, (2) capital loss coverage and yield maintenance, (3) rules on sharing tax benefit, (4) regulatory forebearances and waivers, (5) warrants and profit-sharing, and (6) provisions designed to allow FSLIC to intervene in the activities of the acquired thrift. The Southwest Plan agreements are similar to those negotiated by MAD, but a Standard Southhwest Plan assistance agreement was developed. FSLIC and bidders negotiated differences from that standard.

1. Cash assistance or FSLIC notes

The most straightforward assistance component is the cash or note provided to cover the net worth deficit. Agreements using notes are more common than those with cash. These notes are generally floating rate notes tied to the Treasury Bill rate plus a premium.

2. Capital loss coverage and yield maintenance

Capital loss coverage and yield maintenance agreements are provided by FSLIC to insure acquirers against the price risk associated with "covered" asset such as equity shares in real estate and loans more than 90 days overdue, and to compensate them for the costs of managing these assets. Bidders are precluded by law from conducting a detailed investigation of some of these assets, and usually face substantial uncertainty about their fair market value. To overcome bidders' reluctance to acquire assets with uncertain value, FSLIC typically guarantees that the acquirer will receive book value for the asset, which may be much larger than fair value. That is, to the extent the asset sells for a price less than the covered price, FSLIC will compensate the acquirer for some fraction (often 100 percent) of the loss. If the asset sells for a gain, most agreements allow the acquirer to share some amount (usually 10 percent) of the gain.

Until such time as the covered assets are sold, FSLIC guarantees acquirers a cash yield, calculated as a percentage of the book value. The "yield maintenance" rate is usually equal to the cost of funds prevailing in the acquired thrift's region (i.e., average rate on thrift liabilities) plus basis points.

3. Tax benefits

For acquisitions completed before December 31, 1988, all FSLIC assistance payments -- including yield maintenance, capital loss coverage, and interest on FSLIC notes -- are tax free. Since much of the income thrifts earn is tax-free, a typical thrift is likely to generate operating losses for tax purposes; these losses can be utilized to reduce taxes on other, profitable operations. In cases where a troubled thrift is merged with another thrift, its pre-acquisition net operating loss carry-forward may also be used to offset taxable income. In such cases, the acquirer may also be allowed to deduct so-called "built-in" losses that arise when covered assets are sold for less than book value.

Each assistance agreement specifies how these tax benefits are divided between the acquirer and FSLIC. In a small minority of the 1988 assisted acquisitions, acquirers retained 100 percent of the tax benefits. In the the others, acquirers must rebate some or all the tax savings from a certain source (e.g., operating losses) to FSLIC. In these cases, acquirers are required to report to FSLIC actual tax returns and calculate what their tax payments would be if they had not acquired the thrift, and rebate to FSLIC its share of the difference.

4. Regulatory forbearances

FSLIC forebearances grant the acquirer relief from supervisory action for non-compliance with statutory and regulatory provisions where the problem assets or liabilities of the failed thrift cause this non-compliance. These forebearances include relief from liquidity requirements and rules affecting the calculation of regulatory capital.

5. Warrants and profit-sharing plans

Assistance agreements sometimes include warrants that give FSLIC the right to acquire stock in the acquired thrift at some time in the future. FSLIC cannot technically own stock, but it can sell these warrants if they become valuable. In some other agreements, FSLIC was granted a share of the acquired thrift's profits.

6. Provisions to permit FSLIC intervention

Assistance agreements also contain a wide variety of provisions that allow FSLIC to intervene in the thrift's management in order to protect its interests. These provisions allow, for example, FSLIC to force acquirers to sell some fraction of covered assets, or to record a "terminal write-down" that is treated as the equivalent of a sale.

C. AN ANALYSIS OF THE MARKETING AND NEGOTIATION PROCESS

Both MAD and the Southwest Plan Division expressly attempted to make the bidding process as competitive as possible by attracting a large number of bidders. They were successful in this regard as they received multiple bids for most thrifts marketed in 1988. This multiplicity of bidders provided FSLIC protection from "low ball" bids. FSLIC's efforts to expand the number of bidders were therefore appropriate.

It is more difficult to evaluate FSLIC's selective attempts to expedite negotiations with some bidders. On the one hand, if the growth rate in the deficit net worth of thrifts in 1988 exceeded the interest rate, expedited processing would have helped limit the magnitude of FSLIC obligations. On the other hand, if FSLIC has taken a consolidated U.S. government perspective, it should have ignored the December 31, 1988 deadline for the expiration of important tax benefits. Those tax benefits may have reduced FSLIC's cost of assisted acquisition, but not the cost from a consolidated government perspective. Moreover, while "take or leave it offers" have certain advantages, their use also has potential costs in that acquirers had the incentive to accept the favorable deals (i.e., the deals that were costly to FSLIC) and reject the less favorable ones.

D. ANALYSIS OF THE CONTRACTUAL TERMS OF THE ASSISTANCE AGREEMENTS

An analysis of the 1988 assistance agreements reveals that (1) the agreements create incentive problems, (2) the terms introduce potentially significant sources of valuation error, and (3) they make the negotiation process less efficient.

1. Distortion of Incentives under the Assistance Agreements.

A potentially serious difficulty with the terms used in the assistance agreements is that they distort incentives to liquidate covered assets in an orderly fashion and to manage them efficiently prior to sale. FSLIC has included terms in the contracts to mitigate at least some of these problems, and has the right to monitor post-acquisition activity closely. Nevertheless, monitoring is costly and never perfect. Thus FSLIC monitoring will not be able to overcome all of the incentive problems created by the agreements.

Incentive issues related to yield maintenance and capital loss coverage agreements. Recall that the yield maintenance agreements are designed in part to overcome the acquirer's incentive to sell assets quickly, possibly before a buyer willing to pay market value has been identified, in order to accelerate the receipt of capital loss coverage payments. In some rare instances, the yield maintenance agreement may not supply sufficient inducement to hold assets, and the incentive to "dump" assets at bargain prices remains. (This incentive to realize quickly the "built-in" losses is most likely to exist when the firm retains the tax benefit of the those losses, but rebates the tax benefit of the yield maintenance payments to FSLIC.)

In almost all contracts, however, the effect of the yield maintenance agreement can be strong enough to encourage acquirers to hold covered assets until the end of the assistance period. This raises, however, the possibility of a distortion favoring holding onto a covered asset. Unless FSLIC's monitoring of asset disposition forces the acquirer to sell the asset, FSLIC would be obligated for assistance payments until the end of the yield maintenance period.

The incentive to defer sale stems from the form of the yield maintenance agreement. Yield maintenance payments are guaranteed by the government and hence carry no credit risk. Since the yield maintenance rate is reset periodically (according to a formula in the assistance agreement) to reflect current market rates, the acquirer bears little interest rate risk. These features make the capital loss coverage/yield maintenance assistance equivalent to a riskless security, i.e. a Treasury Bill. Moreover, the assistance is more desirable than a Treasury Bill as it (i) yields more than the Treasury Bill rate, and (ii) some fraction of the yield assistance is tax free (except in the infrequent cases where FSLIC retains 100% of tax benefits).

While the acquirer must bear some management costs associated with the asset, if an acquirer sells an asset he loses this desirable yield. Often investments of equivalent risk would not generate as high a yield, especially on an after-tax basis. Thus, unless the costs of managing an asset are

particularly high, the acquirer has the incentive to defer this sale as long as possible. This incentive is reinforced in cases where capital losses on covered assets are borne partially be the acquirer. In those cases, the acquirer does not realize the full book value upon sale, and can reinvest only some fraction of book value. By deferring sale, however, he would continue to receive an above market yield on the whole book value.

The capital gain sharing does not radically affect the acquirer's incentives to defer sale. This is particularly true when the asset's market price is far below the level above which gains are shared. Even when the asset's market value is above the minimum gain sharing price the incentive to defer sale still exists. Capital gain sharing combined with yield maintenance essentially grants the acquirer a valuable call option: he can choose the time to realize this capital gain. It is well known that the owner of a call rationally defers exercise under most circumstances. Moreover, if the call pays a yield this incentive to defer the call (i.e. sale) is strengthened. Since the capital loss coverage/yield maintenance contract with gain sharing is equivalent to a position in a risk free bond and a yield paying call, the incentive to delay sale still exists.

FSLIC recognizes the incentives to hold assets longer than necessary to identify buyers willing to pay market value. Assistance agreements empower FSLIC to force the acquirer to sell or write-down covered assets (in exchange for receipt of the book value guaranteed by FSLIC) under certain circumstances.

FSLIC structures many agreements so that over time the yield maintenance rate approaches the prevailing cost of deposits. Some contracts also include a schedule by which the "strike price" on the gain sharing option increases over time. That is, FSLIC reduces the potential gain the acquirer will realize by increasing the benchmark price of the covered asset according to a specified schedule. This gives acquirers an incentive to identify buyers and to speed up the sale of assets for which the acquirer can realize gains, since over time the difference between the market value and the benchmark price may get smaller. For those assets which the acquirer cannot realize a share of the gains through sale because their price is too low, however, the increases in the strike price specified by the contract make it more likely that the sale of the asset will be deferred.

The overall effectiveness of these various provisions is uncertain. First, FSLIC can force sales of assets only by undertaking costly monitoring activity, and that monitoring cannot be perfect so FSLIC will not be able to completely counteract the incentives to defer sale. Second, the declines in the size of the interest rate premium paid as part of the yield maintenance will often fail to overcome the incentive to hold assets when that (tax free) rate exceeds the (after tax) rate on assets of equivalent risk.

In summary, the capital loss coverage/yield maintenance terms of the assistance contract create important incentive problems. These incentive problems arise because the provisions link two conceptually different functions: the provision of financial assistance to resolve insolvency and the efficiently and orderly disposition of problem assets owned by troubled thrifts. The incentives of acquirers to oversee the efficient and timely sale of these assets are therefore distorted. As discussed later, however, these forms of assistance should not necessarily be eliminated, as they reduce the risk that potential acquirers must bear and therefore the amount of other forms of FSLIC assistance.

Incentive problems related to the maximization of income from covered assets prior to sale. Covered assets can potentially generate interest or

rental income. FSLIC's yield maintenance agreement compensates acquirers for difference between the actual yield on the covered assets and the yield maintenance rate.

A potential problem with this arrangement is that it provides no incentive for acquirers to maximize the actual income on the covered assets. In fact, there is often an incentive to minimize that source of income because this rental or interest income is fully taxable, but yield assistance payments are tax free. Unless the tax benefits are rebated in full to FSLIC, the acquirer is better off, the less income is generated by the covered assets.

This incentive problem is exacerbated to the extent that income from the covered asset is a function of acquirer effort. For example, an acquirer would typically have to incur costs to attract new lessees to a shopping center, but to do so would cause a reduction in after tax income from yield maintenance. On the other hand, if the acquirer shirks and rental income from the shopping center falls, the acquirer's after tax income rises.

2. Valuation Problems Created by Contract Terms.

The value of the assistance terms specified in an assisted acquisition agreement are frequently difficult to estimate. Consequently, valuation estimates will be subject to potential errors, which in turn can have serious consequences.

A simple example serves to illustrate this point. Consider a thrift with a net worth of -100 and a franchise value of -1. This firm could be liquidated at a cost of 100. Assume that a potential acquirer submits a bid for an assistance package including cash, capital loss coverage, yield maintenance, tax benefits, and forebearances which the acquirer (correctly) values at 102. This is an assistance package that would make the bidder willing to take control of the insolvent thrift and continue to run it in order to capture the assistance benefits (namely the tax and yield assistance payments) that are derived from continuing operations. If FSLIC underestimates the cost of this package, at 98 say, it will infer a franchise value of 2 in the bid and would sell the thrift. Given that this solution in fact costs 3 more than liquidation, a valuation error leads to an incorrect resolution decision and higher FSLIC costs. Similar examples can be constructed in which a viable firm is liquidated.

Errors do not impact only the acquisition versus liquidation choice. Due to difficulties in valuing the differences among bids, FSLIC can also make incorrect decisions regarding which bid to accept. While the objective of the process should be to ensure that the acquirer who values the franchise most highly will succeed, other outcomes may occur because of differences in the value of the assistance terms offered.

There are several elements of the assistance agreements that are likely to be the subject of valuation errors. In the remainder of this section we discuss these potential sources of variance. In Section V we discuss the valuation methods employed by FSLIC and their effect on 1988 resolution decisions.

Potential Valuation Errors Created by Yield Maintenance and Capital Loss Provisions. The present value of capital loss coverage and yield maintenance payments depends on the pattern of asset disposition over time Given the lack of a market for many of the covered assets and the conflicting incentives created by yield maintenance and FSLIC monitoring, this pattern will be extremely difficult to predict. Thus any estimate of the cost of yield maintenance and capital loss coverage will be subject to inherent error.

Potential Valuation Errors Created by Tax Sharing. FSLIC would need detailed information about the tax planning opportunities of the acquirer to estimate correctly the expected value of tax benefits. Consequently, FSLIC can only arrive at an imprecise estimate of the value of tax benefits. It might infer franchise value from a bid when the potential acquirer is actually bidding for the tax shelter value of the thrift rather than its economic value. FSLIC could therefore sell thrifts that should be liquidated if it underestimated the true value of tax benefits. Alternatively it could mistakenly liquidate viable thrifts if it overestimated the expected value of tax benefits.

FSLIC could eliminate this potential for error by retaining 100 percent of all tax benefits.

Potential Valuation Errors Created by Warrants and Profit Sharing. The valuation of warrants and profit sharing rights is extremely difficult when the stock of the thrift is not publicly traded and, as is often the case, the underlying distribution of the stock's value is unknown. This makes estimating their value very difficult.

Potential Valuation Errors Created by the Deposit Insurance Contract.

Although FSLIC insurance is not part of the assistance contract per se, the difficulty in valuing the future deposit insurance liability can also lead to valuation errors. Deposit insurance premiums do not reflect the riskiness of the surviving thrift. Even if the premium is fairly priced on average, if acquired thrifts are riskier than the average thrift its insurance premium is too low. Thus FSLIC incurs an expected liability when it sells an insolvent thrift. This represents a cost of sale and should be included in acquisition cost estimates. If it is valued incorrectly, an incorrect resolution decision could result.

Forebearances may cause additional difficulties in this regard. One question is whether the additional monitoring procedures required by FSLIC when forebearances are included in agreements are sufficient to avoid the adverse impact of forebearances on future FSLIC liabilities. It is clear that FSLIC makes substantial efforts through the course of their viability analysis and their negotiation of forebearances to avoid a net increase in liabilities. However, regardless of the success of these efforts, it remains important to consider the difficult problems in valuing the forebearances. Presumably the granting of forebearances increases the value of the agreement to potential acquirers, but FSLIC currently has no methodology to value them.

3. Assistance Terms and the Efficiency of the Bidding Process.

The large number of terms in the assistance agreements and the difficulties of valuing these terms make the bidding and negotiation process cumbersome and time consuming, both for those preparing bids and for FSLIC. The evaluation and comparison of offers to each other and to liquidation cost also becomes more costly as the number of potential contract dimensions increases.

These factors can have serious effects. First, increasing the cost of participating in the bidding process may deter some bidders and reduce the competitiveness of the acquisition market. Second, if the rate of insolvency growth is high, prolonging the negotiation process can increase the size of FSLIC's insurance obligation (see Section II).

E. ALTERNATIVE ASSISTANCE PACKAGES: "CLEAN ASSISTANCE AGREEMENTS"

The foregoing discussion implies that the form of the 1988 assistance agreements may have increased the cost of resolving insolvent thrifts due to a variety of incentive problems, valuation errors, and the use of complex bidding and negotiation processes. To reduce these costs we recommend the implementation of an alternative form of assistance agreement. This "Clean Assistance Package" would attenuate many of the incentive and valuation problems discussed above. It would also streamline the negotiation process.

Naturally, in reducing or eliminating certain forms of assistance -- tax benefits and forebearances -- the "Clean Assistance Package" approach will require increased cash or a larger FSLIC note. As discussed throughout the report, the liquidity constraint issue is relevant to evaluating FSLIC's 1988 resolution activity. Our purpose in defining in detail the aspects of the clean approach is to indicate a better course of action in the future.

1. *Key features of the approach.*

The Clean Assistance Package would fix the contract terms for a thrift or group of thrifts to be sold prior to bidding. This does not require the use of the same contract terms in all acquisitions, but does (i) require that bidders make "all in" bids equal to the amount of assistance (in cash or principal value of a note with given maturity and coupon) required to induce the acquirer to assume the assets and liabilities of an insolvent thrift and (ii) rules out negotiation on the contract terms. Therefore, instead of negotiating a wide variety of terms, each bid would be in present value terms and would require no analysis. This would allow easy comparisons of the bids of competing acquirers to each other and to the cost of liquidation.

This element of the clean package is of paramount importance. Whatever the contract terms used, the "all in" nature of the bids eliminates the difficulties inherent in comparing bids with different attributes and avoids the pitfalls of FSLIC negotiating contract terms with parties who may have information advantages in assessing the value of various forms of assistance.

Next, regarding the contract terms themselves, the "clean" package would require acquirers to rebate 100 percent of tax benefits to FSLIC in order to eliminate the potential valuation errors. As indicated above, differences in the ability of the potential acquirers to use tax advantages may result in an ordering of bids that does not reflect the ability of the potential acquirers to manage the thrift's operation. Since the preservation of franchise value should be (absent FSLIC liquidity constraints) the motive for acquisitions, eliminating the types of valuation error that can lead to a failure to maximize franchise value makes sense.

The clean package would also exclude all forebearances and the granting of state branching rights as part of assisted acquisitions. The state branching rights reduce the other forms of FSLIC assistance and so liquidity constraints may explain their inclusion in the past. But inclusion of rights adds complexity to the deals, raises questions about the potential impact on other thrifts within the state, and may add to expected FSLIC liabilities. The granting of state branching rights should, therefore, be separated from assistance agreements.

Forebearances also may add to FSLIC exposure by increasing the probability that an acquirer will become insolvent. As indicated above, FSLIC makes substantial efforts to mitigate the potentially adverse effects of forebearances, but insofar as forebearances add to the option value of the FSLIC insurance contract, the bidding process will tend to attract firms who value the forebearances most highly. This may lead to selection of less desirable bidders. The bidding process hopefully would protect FSLIC by making such potential acquirers pay for the option value inherent in the FSLIC contract, but there is no clear advantage in taking the risk that forebearances will increase the probability of a future insolvency. As discussed above, the FSLIC insurance contract is poorly structured and relying on monitoring to overcome flaws that may be aggravated by forebearances is not a good strategy.

The package would eliminate the practice of the FHLBB accepting warrants as part of the negotiated agreements. Warrants protect the FHLBB from the possibility that in their negotiations they did not correctly evaluate all the likely benefits offered to acquirers. Warrants also are another mechanism for sharing risk. With the clean approach, however, warrants as a form of protection are not needed and frustrate the objective of making easy comparisons of bids possible. While warrants are a tool for risk sharing, other terms that can be fixed for all bidders are available.

The package would ideally limit the use of capital loss and yield maintenance in order to avoid the incentive and valuation problems associated with these provisions. The primary motive for eliminating these terms is that they distort incentives to sell assets. However, some of the adverse incentive effects of yield maintenance identified above would not arise if the tax benefits did not accrue to acquirers. Furthermore, as the following discussion indicates, acquirers may need guarantees to encourage acceptance of assets. Therefore, in practice there is a tradeoff between the benefits from reducing the risk imposed on acquirers and the adverse incentive effects.

2. Asset ownership and management features.

There are several alternative ways to structure the remaining features of the Clean Assistance Package relating to asset ownership and management. The key point in the discussion that follows is that whatever structure works best should be chosen. It should be noted as well that the following comments apply as well to issues concerning liquidation. The issues in dealing with problem assets either through liquidation or assisted acquisition are essentially the same. Differences in the efficiency of the two alternatives, insofar as the disposition of assets is concerned, must be traceable to differences in incentives to manage and sell assets. The wide range of tools to structure incentive contracts, however, should permit asset disposals to be handled as efficiently in liquidations as in assisted acquisitions.

The first approach is to include all of the thrift's assets, good and bad, in the sale without any capital loss coverage, yield maintenance, or other forms of compensation. Under this system bidders would bear all the risk associated with the problem assets and would have control over their disposal. Eventual acquirers would thus have an incentive to maximize the value of these assets. FSLIC experimented with moving in this direction in its Expedited Case Processing (ECP) for small thrifts. Under this program potential acquirers submit the value of the assistance that they require to assume a troubled thrift. FSLIC pays this assistance with a combination of cash (20 percent) and notes (80 percent).

The problem assets owned by insolvent thrifts, however, may make this method impractical. Given the fact that there are only inefficient markets for some assets, it may be very costly for FSLIC or potential acquirers to value them. Moreover, estimates of asset values are subject to extreme error. Since acquirers bear all risks of non-performing assets, they may require substantial discounts to absorb this risk. These discounts may consequently increase the cost of acquisition bids. However, this approach should not be rejected out of hand as (i) it is simple to administer, requiring no further classification of assets, (ii) by excluding capital loss coverage and yield maintenance, it eliminates incentive problems, (iii) acquirers may develop the skills needed to make bids on this basis, and (iv) the risk associated with problem assets must be borne by someone.

Secondly, FSLIC could retain ownership of the bad assets and sell "good thrifts" containing only performing, marketable assets on an "all in" basis.

As in the case of 100 percent capital loss coverage terms, FSLIC would bear the risk associated with these assets under this arrangement. It could then devise means to maximize the value of the affected assets, and thereby reduce the cost of resolving its insurance liability. FSLIC, for example, could delegate this task to professional asset managers and specialists in the workouts of non-performing loan.

Such alternatives to the standard receivership approach may represent more efficient solutions. In stripping out problem assets, the fundamental incentive problems are no worse, and yet some economies of scale through liquidation may be achievable. One disadvantage with this approach is the problem of classifying assets.

The third approach is to include in the agreement some form of risk sharing. In discussing the means to do so, it should be kept in mind that whatever terms are used, they should be fixed before the bidding process and not subject to negotiation. The most basic forms of risk sharing are rules that assign shares of the proceeds to the acquirer and to FSLIC when assets are sold, e.g., 20 percent to the acquirer and 80 percent to FSLIC. To encourage the acquirer to make better decisions about the sale of the assets, the share to the acquirer can be increased according to a schedule, e.g., 30 percent of the first $100,000; 60 percent of the next $100,000; and 90 percent of the additional proceeds.

Risk can also be reduced by either capital loss coverage on non-performing assets or yield maintenance. Capital loss coverage obviously reduces the downside risk to the acquirer. These reduce risk and mitigate the problem of valuing bad assets. As discussed above, however, capital loss coverage alone would create incentives to sell assets quickly (to realize the capital loss coverage payments). This could be mitigated by yield maintenance or by sharing rules. The effect of these on incentives depends, therefore, on the combination of the terms and the prevailing market conditions.

In this sense the tradeoff of the benefits from risk sharing and the costs from distorting incentives is fundamental to all risk sharing arrangements and not remediable by the "clean" approach. Such risk versus incentives problems are common in virtually all property management contracts. Nonetheless the clean approach can reduce these costs by separating out tax related effects and by establishing a bidding process whereby the set of bidders will bid on the same package of terms. FSLIC will thereby establish rules that allow it to take full advantage of the bidding process.

3. Overall Advantages of the Clean Assistance Package.

The approaches that can be used with the Clean Assistance Package would allow FSLIC to take advantages of differences in the management abilities of potential bidders. Those bidders with varying levels of expertise in managing problem assets and managing a thrift could focus on deals with the best mix of each. Further, the potential unbundling of non-performing asset management from thrift management does not constrain FSLIC's options: it can only increase them. If certain acquirors are particularly efficient managers of bad assets, or if there are synergies between asset management and thrift management, then thrift acquirers will be the low cost asset management contractors. If such economies do not exist, then FSLIC could reduce resolution costs by contracting with more efficient asset managers.

The key advantage is that by making the contracting system as competitive as possible, FSLIC could capture any of these extant efficiencies of specialization, synergy and scale. If for example the bidding process over time reveals that there are economies of scale in managing bad assets (but not

in the management of thrifts), then the problem assets of several thrifts could be consolidated and managed by a single agent while the remaining assets and liabilities of the thrifts could be sold to several acquirers. Exploiting such economies of specialization or scale would reduce the costs of resolution.

The advantages of improved incentives, specialization, synergy and scale associated with the Clean Assistance Package approach are not restricted to the acquisition alternative. FSLIC could also design liquidation management contracts containing sharing provisions, monitoring and poor performance sanctions, and also let these contracts out for competitive bid. Doing so would presumably lower the costs of liquidating insolvent institutions. Using similar methods to dispose of problem assets in liquidation and acquisition provides an additional benefit: It would eliminate a source of error in the comparison of the costs of the two methods. If bad assets are stripped out of acquired thrifts and managed as under a liquidation, for example, FSLIC would bear the same management costs under both resolution alternatives. Thus the form of asset management cannot be a source of cost differences between the two alternatives. (FSLIC bears the same price risk under liquidation, the clean assistance package or under assistance packages containing capital loss coverage provisions, so this should not affect the relative costs of the various alternatives either.)

In summary, a "Clean Assistance Agreement" along the lines described above could serve to streamline the resolution process, reduce perverse incentives, limit the scope for valuation error, and improve the efficiency of the management of troubled assets. All of these would serve to reduce resolution costs. Of course this approach would not correct the major remaining source of error and distorted incentive -- the structure of the deposit insurance contract. For this reason, issues remain regarding the acquisition versus liquidation decision. But if assisted acquisitions are pursued in the future, the Clean Assistance approach would markedly improve the efficiency of the resolution process.

V. ANALYSIS OF THE FSLIC METHODOLOGY FOR EVALUATING BIDS

As indicated in section III, the ideal approach for making the liquidation versus acquisition decision would be for FSLIC to measure directly thrift franchise value. If a positive franchise value exists, FSLIC would attempt to capture that value in sales to acquirers. If no franchise value exists, the thrift would be liquidated provided that the problem assets can be managed by a receivership without too great a loss in efficiency.

Even though FSLIC does not measure franchise value directly, it can potentially capture that value if the bidding process is competitive, and if FSLIC is able to identify which bid is highest. However, identifying the highest bidder is a complicated task. The contractual terms of the 1988 deals were complex, and bids varied across bidders on a variety of dimensions. The purpose of this section is to evaluate the methodology used by FSLIC to compare bids, and to compare the cost of solution via acquisition to the cost of liquidation.

This section is organized as follows. In Part A, we briefly discuss the structure of FSLIC's model for evaluating the cost of assisted acquisition and the cost of liquidation. In Part B, we present four important adjustments that could improve FSLIC's cost evaluation significantly. Part C discusses the discounting of uncertain cash flows for which FSLIC is responsible. Part D summarizes the adjustments and presents a brief empirical analysis of the impact of accounting for such factors in the acquisition/liquidation choice. Part E calibrates the potential magnitude of the adjustments with respect to 83 of the 1988 assisted acquisitions. In Part F, we estimate how these factors might have affected the evaluation of the Bass Group bid for America Savings and Loan. Conclusions are presented in Part G.

A. THE STRUCTURE OF FSLIC'S EVALUATION METHODOLOGY

The standard methodology used by FSLIC generates an estimated cost of solution via acquisition (COS), based on specific bids, and compares those with the estimated cost of liquidation (COL). The least cost alternative is selected. This determination is inherently difficult, because COS and COL cannot be estimated with precision. As indicated in Section IV, the costs of liquidation are often based on fairly crude information about the condition of insolvent thrifts. Some of the imprecision is the unavoidable consequence of an uncertain world. The task faced by FSLIC is to minimize the imprecision that is avoidable.

Both COS and COL are estimated using a "discounted cash flow" technique. Under this technique, expected cash outflows and inflows are forecast for each year of the contract. Those future cash flows are then discounted to arrive at an estimated present value.

Under the liquidation alternative, there is an assumed immediate cash outflow to pay off depositors. Over future years, cash inflows from sales of assets are expected, and may be netted against remaining liabilities and expenses. The present value of those cash inflows are always less than the cost of paying depositors.

Under the acquisition alternative, there may be little or no immediate cash outflow. However, FSLIC faces future cash outflows in several forms, primarily payments on notes given to the acquirer, payments on yield maintenance agreements, and payments on capital loss coverage agreements. These cash outflows were explicitly accounted for under the standard FSLIC methodology. In some contracts, FSLIC can partially offset these cash outflows with cash inflows from profit-sharing, warrants, and rebates of tax benefits granted to the acquirer. However, these cash inflows were excluded

from analysis under the standard methodology. As indicated below, they were considered explicitly in certain December deals.

B. ADJUSTMENTS TO IMPROVE COST EVALUATION

1. Recognition of the expected cost of future failures of acquired thrifts.

When insolvent thrifts are recapitalized and preserved through sale to an acquirer, there is a positive probability that the thrift will fail again in the future. At least some of the costs of that failure will be borne by the FSLIC. If FSLIC provides subsidized insurance to the acquired thrift, the expected amount of these costs will tend to exceed the insurance premiums received from the thrift. The cost of this subsidy could be at least partly avoided by liquidation, and thus is properly regarded as a cost of sale. However, in estimating the cost of solution for the 1988 cases, FSLIC did not explicitly recognize the expected cost of future failures of currently-acquired thrifts. An adjustment to recognize this cost would tend to favor the option to liquidate thrifts, rather than preserve them through assisted acquisition.

Two issues exacerbate the impact of this cost. First, many of the 1988 acquisitions were structured with forbearances. That is, FSLIC exempted the acquirer from certain regulatory requirements (e.g., normal capital maintenance requirements) for some period of time. A relaxation of regulatory requirements tends to increase the probability of future insolvency, and therefore the expected future cost to FSLIC. In particular, although FSLIC asset guarantees and yield maintenance reduce the riskiness of a thrift's portfolio (thereby lowering the probability of failure), the forebearances frequently grant acquirers the right to engage in higher risk strategies in the future.

The second issue concerns the type of acquirer who would be willing to pay a high price to obtain a thrift. Part of the value of the thrift to a potential acquirer derives from the subsidized nature of deposit insurance, and the fact that the insurance premium does not vary with risk. This subsidy is more valuable to those bidders who plan to undertake risky projects. Moreover, its value is maximized when the acquired thrift is thinly capitalized (see section II.A.). Thus, the most aggressive bidders may be those who intend to exploit the deficiencies in the insurance system. Of course, FSLIC can mitigate this problem through careful monitoring in the post-acquisition period, but that monitoring is costly and cannot be perfect. These considerations make the evaluation of competing bids very difficult. FSLIC cannot be sure that a bid is high because the acquirer is able to utilize the assets of the thrift effectively (i.e, realize high franchise value), or because the acquirer values the ability to engage in risky projects without being fully responsible for the downside risk.

Proper techniques for the valuation of the FSLIC's deposit insurance guarantee are provided by modern option pricing theory. Although the conceptual issues underlying such techniques are well understood, explicit valuation is difficult. Modern option pricing theory can be applied, given reasonable assumptions about interest rate volatility, economic volatility, and the like, but the task is not straightforward. However, when potentially more than 50 to 100 billion dollars are at stake, efforts to come to grips with option theory valuation of deposit insurance would be productive.

2. **Recognition of the value of core deposits under the liquidation option**

In estimating the cost of liquidation, FSLIC assumes that it will pay off deposits in cash, rather than transfer them to another thrift. FSLIC frequently transfers deposits during a liquidation, however. In such cases,

firms assuming the deposits are typically willing to pay a premium in order to obtain the marketing advantages inherent in the transferred core deposits. The option to transfer core deposits to another institution at a premium implies that the FSLIC's estimated cost of liquidation should be adjusted downward.

Whereas the methods of valuing the put option implicit in deposit insurance are difficult, simple methods exist for making adjustments for the core deposit premium. Actual sales of such deposits generate premiums in the range of 2 percent to 6 percent. The premiums received in these sales could be used to estimate the core deposit value for resolution candidates. If a rate of, say, 3 percent is applicable, one could simply apply that factor to the core deposit base to arrive at the core deposit premium.

3. **Recognition of the tax benefits passed to acquiring firms**

Acquisition of the insolvent thrifts can potentially confer several tax benefits to the acquirer: tax-free assistance payments from FSLIC, ability to utilize a thrift's current operating losses (and, in some cases, past operating losses) to offset taxable income from other sources, and the ability to deduct "built-in" losses on assets whose market value declined below book value prior to the acquisition. FSLIC was fully aware of these tax benefits, and in many cases required that the acquirer rebate at least a portion of them to FSLIC. However, the acquirers frequently retained some portion of the tax benefits.

One important question is whether competition among bidders drove them to compensate FSLIC fully for the tax benefits they received by reducing the other forms of financial assistance they required to assume an insolvent thrift. That is an empirical issue that will be addressed in section VI of this report. Regardless of whether the acquirers "paid" FSLIC for these tax benefits, though, the transfer of the benefits represents a cost to the U.S. Treasury, and hence a cost from a consolidated government perspective.

Prior to December 1988, the methodology used by FSLIC to evaluate bids generally did not explicitly recognize the cost of tax benefits passed to acquiring firms. To that extent, under a consolidated government approach, the cost of solution through acquisition was understated. This would tend to lead to a bias toward acquisition, as opposed to liquidation. The standard FSLIC methodology also generally excluded from the cost of solution that portion of the tax benefits that are "rebated" to the FSLIC. Since these "rebates" essentially represent a transfer from the U.S. Treasury to FSLIC, they are irrelevant and should be ignored, if not from FSLIC's perspective, certainly from a consolidated government perspective.

In evaluating the level of tax breaks associated with the 1988 deals, FSLIC has developed a methodology that has the virtue of being straightforward and easily implemented. Although not developed until January, 1989, it represents a good first step. Given the importance of these tax issues, however, further development is desirable. In assessing the tax benefits, one should bear in mind four issues that may imply that the tax benefits granted to acquirers are greater than expected.

First, the benefits are estimated under an assumed 34 percent corporate tax rate. Since it is unlikely that this rate will go lower, but might be higher in the future, the value of the tax benefits could be larger.

Second, some of the estimates assume that operating losses of the acquired thrift will not be fully utilized, because the thrift (or its acquirer) will not have sufficient income from other sources to fully absorb the losses. However, that income may be higher than expected, due either to real economic changes, or tax planning schemes that could accelerate the recognition of income.

Third, where the acquiring firm is not a thrift, but has a thrift subsidiary, there are additional approaches to tax planning that could increase the value of tax benefits granted to acquirers. In these cases, the subsidiary thrift can potentially utilize the "built-in" capital losses and net operating loss carryforwards of the troubled thrift, but only if the subsidiary thrift has sufficient taxable income. Wise tax planning in such a situation would involve shifting of income from the non-thrift parent to the subsidiary thrift. There exist a variety of mechanisms for accomplishing that objective.

FSLIC attempts to incorporate at least some of the above considerations in its estimate of tax benefits. However, an accurate assessment of expected tax benefits would require detailed information pertaining to the tax planning opportunities of the acquirer. FSLIC is unlikely to possess such information, and acquirers have no incentive to supply it. If FSLIC has underestimated the value of the tax benefits, then the cost of assisted acquisition from a consolidate government perspective (as opposed to the perspective adopted in the FSLIC methodology) is understated.

4. Recognition of the effects of incentive problems created by yield maintenance and capital loss coverage agreements

Given the contractual arrangement between FSLIC and acquirers, there are incentives for the acquirers to transfer wealth from FSLIC to themselves. As discussed in section IV, the yield maintenance and capital loss coverage agreements create such incentive problems. As also discussed, FSLIC has included terms in the contracts to mitigate at least some of these problems, and has the right to monitor post-acquisition activity closely. Nevertheless, monitoring is costly and never perfect. The costs of monitoring acquirers, as well as the costs extracted from FSLIC when monitoring is imperfect, serve to make acquisitions more expensive. Since these costs are ignored in FSLIC estimates of the cost of solution through acquisition, those estimates are understated. To the extent these costs could be avoided in liquidation, there is a bias in favor of assisted acquisitions.

Because of the incentives in the yield maintenance agreement, FSLIC can expect to bear the costs of (1) delays in asset sales and extensions in assistance payments, (2) lower proceeds from sale of covered assets, in cases where asset values are in the range where there are no strong incentives for acquirers to maximize sales price, and (3) monitoring to mitigate these problems. FSLIC failed to incorporate, however, any explicit measure of these costs in its 1988 analyses. In assuming that acquirers would sell bad assets at the same time and in the same amount as FSLIC would during a liquidation, their approach tends to understate the estimated cost of solution, which tends to favor assisted acquisition rather than liquidation.

Note that if potential acquirers incorporate incentive effects and the value of receiving above market returns into their pricing of assistance packages, they may be willing to pay to obtain more generous yield maintenance terms. Truly competitive bidding forces them to do so. Nonetheless, in order to compare bids and to compare the cost of merger to liquidation it is still necessary for FSLIC to calculate the effects of the incentive problems. Incorrect estimates of the cost of yield maintenance/capital loss coverage would lead FSLIC to err in its estimates of franchise value implicit in the various bids. This could cause incorrect resolution decisions and consequently raise the cost of meeting insurance obligations to depositors at insolvent thrifts.

Incentive problems associated with asset disposal are not unique to the option of assisted acquisition. Such problems can also arise in liquidation, as assets are managed by a receivership. To that extent, an adjustment to increase the cost of liquidation may be needed. However, differences between the efficiency of assisted acquisitions and liquidations in selling problem assets must be traceable to differences in incentives. A properly structured incentive contract should permit asset disposals to be handled as efficiently in liquidation as in an assisted acquisition.

C. ISSUES IN DISCOUNTING RISKY CASH FLOWS

One important aspect in any evaluation of financial projects is risk. Holding all else constant, a project is less valuable, the more risky it is. The same concept applies to measuring the value of savings associated with selling a thrift, rather than liquidating it. If the cash flows associated with the savings are risky, then the savings are less valuable, making the acquisition alternative less desirable.

A common approach to recognizing risk is to estimate the expected cash flows for a project, and then to "discount" those cash flows at a higher rate, the riskier they are (see Brealey and Myers, [1984, Chapter 9]). FSLIC does recognize the need to allow discount rates to vary with risk (FSLIC/AED Policy Manual, page E-56). Nevertheless, there remain issues that affect FSLIC's approach: (1) most, if not all cash flows are still discounted at a rate equal to FSLIC's cost of funds, which does not properly reflect the riskiness of the cash flows, (2) even when FSLIC uses a discount rate that reflects risk, it yields incorrect solutions, and (3) given that the cash flows have certain characteristics of options, it is not clear that the standard approach of discounting expected cash flows (even with rates that reflect risk) is conceptually sound. As discussed below, it is difficult to assess the impact of these difficulties, but it appears that they may have led to a bias toward acquisition, as opposed to liquidation.

1. **Discounting at FSLIC's cost of funds.**

In each of the bid evaluations we examined, projected cash flows were always discounted at the FSLIC cost of borrowing, as measured by rates on FICO bond offerings. That rate reflects whatever risk investors associate with those bonds. However, that risk is perceived to be low; FICO bond offerings in 1988 never yielded (at original issue) more than 1 percentage point over Treasury bill rates. Certainly, such a low rate does not fully reflect the risk associated with at least some of the cash flows associated with the sales of thrifts. For example, FSLIC bears much (sometimes all) of the risk associated with fluctuations in the values of assets covered by capital loss coverage agreements. If that risk is higher than it would be, had FSLIC liquidated those assets (because of the incentive problems that arise when those assets are sold to an acquirer), then failure to account for that risk introduces a bias in favor of acquisition, rather than liquidation.

2. **Accounting for risk within the context of the FSLIC methodology.**

Given that the cash flows faced by FLSIC are risky, an important question is what risky rate ought to be used to discount those cash flows. As it turns out, the situation is an uncommon one, and so careful application of the modern theory of finance is required.

The cash outflows FSLIC will face, in either an assisted acquisition or a liquidation, are likely to be greater, the slower is economic activity. First, cash outflows will increase as the value of covered assets is depressed. Second, if it takes longer to sell problem assets during a recession, yield assistance payments will be greater. (Other cash outflows-- those necessary to resolve future insolvencies-- will also very negatively with economic activity, but those cash outflows are excluded from FSLIC's analysis.)

Streams of cash that vary inversely with economic activity are highly valued by the recipient, because they represent a hedge against the risk of economic downturns. In the vernacular of modern finance theory, such cash flow streams represent "negative-beta" projects. Because such cash flow streams are so highly valued, they will be discounted at a very low rate (and perhaps even a negative rate) by their recipients. For example, consider the possibility of receiving $200 if economic activity declines, but nothing if economic activity increases. Even though the mean payoff is $100, and will not be received until the future, an investor may be willing to pay nearly $100 now (or even more than $100), because of the hedging value of that payoff.

Whereas cash flow streams that serve as hedges are highly valued by their recipients, they are very costly to those who must pay them. This higher cost is reflected by discounting expected future cash outlays at a low rate, or even negative rate. In terms of present value, the cash outlays are nearly as large, or even larger than the future cash outlays.

An appropriate approach to account for risk in FSLIC's discounting process is to use a low or negative rate, as would be applied in valuing assets that are good hedges against risk. The implication is that the cost of assisted acquisition, as well as the cost of liquidation, would rise. If the cash outflows associated with assisted acquisition are more sensitive to economic downturns (because yield maintenance payments are more likely to "stretch out") then this adjustment would tend to make assisted acquisitions appear more costly, relative to liquidations.

3. Interest Rate Term Structure Issues.

FSLIC notes and yield maintenance payments are generally linked to a short term interest rate (the index rate) such as the T-bill rate. To project its assistance cash outlays, AED assumes that the index rate (and therefore its assistance interest payments) remains constant throughout the term of the agreement. FSLIC discounts these cash flows at the FICO rate to determine the present value of the assistance.

Since the FICO rate is a long term rate this methodology is inappropriate. When long rates exceed short rates (the usual case of an upward sloping term structure) this would tend to artificially depress the cost of solution and therefore make acquisition seem less costly.

Two simple adjustments would help correct this bias. First, FSLIC could use the face value of the notes for the present value in the cost of solution. Second, FSLIC could determine the spread between its borrowing rate (the FICO rate) and the Treasury rate of the same maturity as the FICO bonds, add this spread to the current index rate and use this sum to discount the interest cash flows. These methods would help to eliminate the artificial depression in the cost of solution.

4. The appropriateness of the focus on expected cash flows.

The standard FSLIC methodology discounts cash flows that will be realized in the expected future state of the world. This approach is a common practice in finance, and is conceptually sound in a variety of contexts. It is not conceptually sound, however, in situations where the cash flows have

characteristics of an option--where, for example, cash flow effects might be zero in the expected state of the world, but (on average) non-zero in other possible states. Depending on how the contracts with acquirers were written, several of the cash flow streams to/from FSLIC have option characteristics. In these cases, an approach based on the discounting of cash flows that will occur in the expected future state of the world is inappropriate. How important is this problem, and whether it might have led to a bias toward acquisition or liquidation is impossible to determine without an in-depth, contract-by-contract analysis.

D. SUMMARY OF THE ADJUSTMENT EFFECTS

Several of our suggested adjustments to FSLIC's evaluation methodology would tend to increase the cost of solution via acquisition, or to decrease the cost of liquidation. Such adjustments would, in turn, shift a given case away from the acquisition alternative, and toward liquidation. The sources of these adjustments are summarized as follows:

1) A complete evaluation would explicitly recognise the cost of future failures of acquired thrifts, net of insurance premia to be received from those thrifts. This represents a net cost to the government only under the assumption that FSLIC continues to charge insurance premia that do not reflect the riskiness thrift investments.)

2) A complete evaluation would explicitly recognize that under liquidation, core deposits could be transferred to another thrift at a premium.

3) A complete evaluation would explicitly recognize the tax benefits granted in acquisitions to acquiring firms. Under a consolidated government approach, these tax benefits represent a cost.

4) In certain December deals (Bass, Utley-Ford, Michigan National), FSLIC reduced the estimated cost of solution via acquisition by the amount of tax benefits to be "rebated" to FSLIC. However, from a consolidated government perspective, this does not represent a cost savings.

5) A complete evaluation would explicitly recognize the costs of monitoring acquirers, as well as the value that can be extracted from the government because that monitoring will not be perfect. These costs arise from incentive problems created by (a) yield maintenance agreements and (b) tax benefit sharing agreements.

6) In applying discount rates, one should account for the fact that FSLIC's cash flows in resolution are risky net outflows. Furthermore, some cash flows possess the characteristics of options, and should not be valued by discounting amounts occurring in the expected future state of the world.

Other adjustments would serve to increase the cost of liquidation, relative to acquisition. The most important may be the cost of incentive problems that could arise from allowing a receiver to sell thrift assets.

E. THE POTENTIAL MAGNITUDE OF ADJUSTMENTS TO THE FSLIC METHODOLOGY: AN EXAMINATION OF THE IMPACT ON 84 ACQUISITIONS DURING 1988

Although the adjustments discussed above would tend to work in the direction of favoring liquidation, it remains to be seen whether these potential adjustments are large enough to have significant effects on resolution choice. Moreover, to determine the impact these adjustments could have had on specific decisions would be difficult. However, it is possible to assess some of the potential importance of the adjustments. This section contains such an assessment.

The analysis focuses on 84 of the 86 acquisitions that took place in 1988. (Two of the 86 acquisitions are excluded from the analysis, due to the lack of complete data.) Our approach is as follows:

1) We calculate a "percentage cost savings" due to the choice of assisted acquisition, rather than liquidation. In this calculation, we use the FSLIC estimates of the cost of solution via acquisition (COS) and the cost of liquidation (COL). Percentage cost savings is equal to (COL-COS)/COL. FSLIC's estimates indicate a positive cost savings for 83 of the 84 acquisitions.

2) We then reduce the percentage cost savings by the present value of tax benefits granted to acquirers (as estimated by FSLIC). From a consolidated government perspective, these tax benefits (TXA) represent a cost. The adjusted percentage cost savings is (COL-COS-TXA)/COL. We then determine how frequently the cost savings is negative-- that is, how frequently FSLIC might have chosen the liquidation alternative, were the tax benefits granted to acquirers considered explicitly.

3) Next, we reduce the percentage cost savings by an estimate of the premium on core deposits. This premium could have been obtained upon liquidation, if core deposits were transferred to another institution. In estimating the premium for Southwest Plan cases, we assume that core deposits are 50 percent of total deposits. For the other cases, we have actual data on core deposits. (In these cases, core deposits average 74 percent of total deposits.) We also assume that the core deposit premium is 2 percent for thrifts acquired in the Southwest Plan, and 3 percent for others. (These premiums are within the range of 1 to 6 percent that has been experienced in transfers of deposits to other financial institutions.) The premium (denoted DEP) is then treated as a reduction in the cost of liquidation, and thus as a reduction in cost savings. The adjusted cost saving now equals (COL-COS-TXA-DEP)/COL. At this stage, we once again determine how frequently the cost savings are negative for our sample.

4) Finally, we consider the possibility that COS and TXA have been underestimated by FSLIC. TXA may have been underestimated, either because of a failure to account for the ability of acquirers to enhance tax benefits through careful tax planning, or because future tax rates may rise above 34 percent. COS may be underestimated for a variety of reasons discussed above. It is difficult to know how large these understatements might be; we consider in turn the impact of 5 and 10 percent understatements. Thus, the adjusted cost saving is then either (COL-1.05(COS+TXA)-DEP)/COL, or (COL-1.10(COS+TXA)-DEP)/COL.

The results appear in Table V-1. They indicate that when the above adjustments are made, cost savings for several of the acquisitions become negative. The estimated cost savings become negative for seven acquisitions (8 percent of the 84 cases), as a result of considering the cost of tax benefits granted to acquirers. When a further adjustment for the value of the core deposit premium is also considered, the cost savings become negative for 15 acquisitions (18 percent of the 84 cases). If we assume that the cost of solution and tax benefits are 5 percent higher than estimated, the cost savings become negative for 24 acquisitions (29 percent of the cases). Finally, if those costs are actually 10 percent higher than expected, the cost savings become negative for 31 (37 percent) of the 84 acquisitions.

The cases for which cost savings become negative tend to be larger than average when measured in terms of the cost of liquidation. Table V-1 indicates that the 37 percent of cases for which cost savings become negative when all adjustments are considered account for 58 percent of the total cost of liquidation for the 84 acquisitions.

When the above adjustments are applied to all 84 cases, most of the aggregate cost saving reported by FSLIC is eliminated. Using FSLIC estimates of the cost of liquidation and the cost of solution, we calculate total cost savings to be $7.2 billion. Table V-1 indicates that when all adjustments discussed above are made, this amount falls to $0.3 billion.

The data in Table V-1 suggest that it in many cases, it might have been less costly for the government to liquidate thrifts, rather than preserve them through assisted acquisition. However, in evaluating these results, the reader should recognize that cost savings are difficult to measure, and our adjustments are only intended to be suggestive. Whether in fact it would have been less costly to liquidate is a question that could be answered only upon a more detailed study of the cost of liquidation. If there are costs of liquidation that have been ignored here, then the cost savings might not be negative as frequently as is indicated in Table V-1.

On the other hand, there are other factors that could make the cost savings even more negative. The primary factor would be the expected cost of future failure of the acquired thrifts, to the extent it exceeds insurance premia. If several of the thinly-capitalized acquired thrifts return to an insolvent state, the decision not to liquidate would ultimately prove even more costly than Table V-1 would suggest.

In conclusion, while estimates of cost savings should be interpreted cautiously, it appears that FSLIC's estimates of the cost of assisted acquisition should be adjusted upward, perhaps substantially. This would have implications for forecasts of the ultimate cost of insolvency resolution in the thrift industry. To the extent the adjustments vary across bids, this may also indicate how difficult it is for FSLIC, under the current arrangement, to identify the least-cost bid.

TABLE V-1

SENSITIVITY OF ESTIMATED TOTAL COST FROM ASSISTED ACQUISITIONS IN 1988:
EXTENT OF CASES IN WHICH COST SAVINGS ARE NEGATIVE

Estimate	Number of Cases with Negative $ Cost Savings (1)	Cases with Negative Cost Savings as % of all Cases in 1988 (2)	% of Total Costs of Liquidation Accounted for by Cases with Negative Cost Savings (3)	Total $ Cost Savings (millions) (4)
A. FSLIC estimate of $ cost savings	1	1%	0.4%	$7232
B. $ cost savings, A, after reduction for tax benefits accruing to acquirer.	7	8%	8%	$4467
C. Same as B, except further reduced by the premium on core deposits.	15	18%	17%	$3058
D. Same as C, except for 5% increase in the cost of solution and the value of tax benefits to acquirers.	24	29%	50%	$1742
E. Same as D, except with 10% increase.	31	37%	58%	$258

NOTE: Calculation performed over the 84 of 86 cases for which data on total deposits were available. Total costs of liquidation for these 84 cases = $37.30 billion. Core deposits for Southwest Plan cases are assumed to be 50% of total deposits. Exact values of core deposits used for all other cases. Estimated core deposits for Southwest Plan cases are assumed to carry a 2% premium realizable upon liquidation. The core deposit premium is assumed to be 3% in all other cases.

F. THE POTENTIAL MAGNITUDE OF ADJUSTMENTS TO THE FSLIC METHODOLOGY: AN EXAMINATION OF THE AMERICAN FEDERAL SAVING ACQUISITION

Having examined the potential impact of biases in the FSLIC methodology for the sample as a whole, we now focus on a single acquisition: that of American Savings by the Bass Group. This acquisition is of special interest for two reasons. First, the methodology used to evaluate the bid for American Savings and Loan of Stockton was unique. Second, American Savings and Loan was by far the largest thrift (in terms of total assets) handled in the FSLIC's resolution activity.

The unique methodology used in the evaluation of American was in many ways an improvement over the standard approach. There was no attempt to project and discount complex patterns of future cash flows. Instead, the FSLIC examined the cost of liquidation (approximately equal to the excess of liabilities over the market value of assets), and then focused on how that cost might change if an acquisition took place. This approach is straightforward, yet conceptually sound. It also has the advantage of focusing attention on the economic differences between liquidation and solution through assisted acquisition -- differences that can be obscured under the much more complex standard methodology.

Although the general approach used to evaluate bids for American Savings has advantages, there appear to be some problems in how it was executed. Four such problems are discussed here. First, American Savings held FMAC stock that had appreciated in value, and the Bass Group was willing to pay full value for that stock. However, in calculating the cost of liquidation, it was implicitly assumed that the stock would be sold for book value, thus causing an overstatement in the cost of liquidation and a bias toward the acquisition alternative. Second, the Bass Group was willing to pay some premium for the

ability to assume Federal Home Loan Bank advances that carried below-market interest rates. That premium was considered by FSLIC as a reduction in the cost of solution via acquisition. However, since the below-market rates essentially represent a government subsidy, the government ultimately bears the cost of permitting the advances to remain outstanding. Thus, there is no cost reduction from a consolidated government perspective. The result is an understatement in the cost of solution via acquisition, and a bias toward acquisition. Third, FSLIC overstated its share of federal tax benefits to be rebated, by implicitly ignoring the deductability of state income tax for federal income tax purposes. This leads to a further bias in favor of acquisition, rather than liquidation. Fourth, the tax benefits rebated to FSLIC were counted as a reduction in the cost of solution, whereas from a consolidated perspective, they are simply a transfer across governmental units.

Fifth, there is a difficulty in valuing the warrants--either the warrants granted by Bass to FSLIC were overvalued by FSLIC, or else the thrift was sold to Bass at a bargain price. To see this, consider the value of the warrants as estimated by FSLIC. First, the future value of the thrift's common stock was projected, based on the thrift's business plan and an assumption about the value of its intangible assets. Next, FSLIC's share of that value, as conveyed by the warrants, was calculated. Finally, that future value was discounted (to take into account the time value of money) to arrive at a present value of the warrants.

In principle, such an approach can yield a reasonable estimate of the value of the warrants (stock). However, there exists a simpler approach that is theoretically sound and is likely to be more reliable. Since the exercise price of the warrants is near zero, the warrants are the economic equivalent of common stock. Rather than projecting a future value of the stock, and then discounting it to arrive at a present value, one can simply use a direct estimate of the present value of the stock. Unless FSLIC permitted the Bass Group to acquire the thrift at a "bargain" price, an estimate of the firm's equity equals the Bass Group's capital investment. Given that FSLIC obtained the right to 30 percent of the thrift's stock, the Bass Group investment represents 70 percent of the value of the stock. Thus the value of FLSIC's stock equals the Bass capital contribution multiplied by .43 (i.e., 3/7).

In Table V-2, we report our estimate of the impact of these adjustments on the costs of liquidation and sale for American S & L of Stockton. In evaluating the Bass bid, FSLIC estimated the cost of solution via acquisition to be $1699 million. When compared to the estimated cost of liquidation of $3333 million, the acquisition alternative offers an estimated savings of $1634 million. However, when adjustments are made to account for (i) the addition of tax benefits to reflect consolidated government costs, (ii) the subtraction of the core deposit premium from the cost of liquidation, and (iii) the adjustment of warrant values to reflect the value of the Bass equity, the cost of liquidation falls to $2966 million while the cost of sale rises to $3100 million. Moreover, our estimate of the cost of acquisition could be understated, because it fails to reflect (a) the expected cost of possible future insolvency, to the extent this cost exceeds deposit insurance premiums, (b) any costs associated with the incentive problems discussed above, and (c) the possible incremental riskiness of cash flows arising under the acquisition alternative. Nevertheless, even before considering these issues, the adjustments are sufficient to eliminate the cost savings originally estimated by FSLIC. (FSLIC has already released a revised estimate that reduces cost savings by the amount of tax benefits.)

TABLE V.2

SUMMARY EVALUATION OF BASS GROUP BID FOR AMERICAN SAVINGS AND LOAN

all amounts in millions

FSLIC ESTIMATE OF COST OF LIQUIDATION:				$3333
less: estimated premium on core deposits (obtainable if deposits transferred to other institutions, rather than paid in cash)				
3% x estimated core deposits (3% x 10550)*				(321)
less: excess of market value of FMAC stock over book value (realizable upon liquidation)				(46)
ADJUSTED ESTIMATE OF COST OF LIQUIDATION:				2966
FSLIC ESTIMATE OF COST OF SOLUTION VIA ACQUISITION:			$1699	
plus: tax benefit "rebate" to FSLIC (not a benefit from a consolidated government view)			688	
plus: tax benefits granted to Bass Group (a cost from a consolidated government view)			219	
plus: potential overstatement of value of warrants granted by Bass Group to FSLIC:				
FSLIC estimate of value of warrants:		$650		
Capital infusion by Bass Group:	$500			
Bass share in equity	.70			
Implied present value of total equity	714			
FSLIC share in equity	.30			
Implied present value of FSLIC warrants		214		
Potential overstatement in value of FSLIC warrants			436	
plus: premium offered by Bass for subsidized FHB loans (not a benefit from a consolidated government view)			58	
ADJUSTED ESTIMATE OF THE COST OF SOLUTION VIA ACQUISITION, IGNORING COST OF POSSIBLE FUTURE FAILURE OF THRIFT:				3100
ADJUSTED SAVINGS (ADDED COST) OF ACQUISITION, IGNORING COST OF POSSIBLE FUTURE FAILURE OF THRIFT:				(134)

*See details of estimate on following page

ADDENDUM TO TABLE V-2

ESTIMATE OF PREMIUM ON CORE DEPOSITS
AMERICAN SAVINGS AND LOAN
all amounts in millions

Total deposits, 9/30/88:		$15290
Calculation of core deposits as fraction of total deposits, 12/31/87:		
Passbook accounts	924	
Money market accounts	2230	
Fixed-rate, fixed term certificates	9199	
Subtotal	12353	
Total Deposits	17062	
Subtotal as fraction of total:	72%	
Reduction, to exclude possible brokered deposits:	(2%)*	
Estimated core deposits as fraction of total deposits:		70%
Estimated core deposits, 9/30/88		10703
Assumed percentage core deposit premium		3%
Estimated core deposit premium		321

*Brokered deposits represent 4% of total deposits; it is assumed that half of the brokered deposits are included in fixed-rate, fixed-term certificates.

Whether in fact it would have been less costly to liquidate American S & L of Stockton is a question that cannot be answered without a more detailed investigation of the cost of liquidation. No thrift as large as American has ever been liquidated. In any case, however, it appears that the cost of assisted acquisition as estimated by FSLIC should be adjusted upward substantially.

G. SUMMARY AND CONCLUSIONS

In this section, we have evaluated the methodology used by FSLIC to choose between liquidation and assisted acquisition, and among alternative bids from potential acquirers.

Given the existing arrangement for selling troubled thrifts, evaluation of competing bids and the option to liquidate is inherently difficult. We have suggested several ways in which the evaluation process could be improved. In general, the adjustments would either make assisted acquisitions appear more costly, or make the option to liquidate appear less costly. The primary exception is the cost of incentive problems that might be faced in permitting a receiver to manage problem assets. Overall, however, it appears likely that taking all adjustments into account would tend to make the liquidation option more attractive to the government.

We reviewed 84 of the 86 acquisitions of 1988, and considered that subset of adjustments that can easily be quantified. We also considered the possibility that additional adjustments could increase the cost of assisted acquisition by 5 percent. Under this scenario, the adjusted cost of assisted acquisition for 29 percent of the 1988 resolutions (representing 50 percent of the total cost of liquidation) exceeded the adjusted cost of liquidation. When the additional adjustments increase the cost of assisted acquisition by

10 percent, that cost exceeds the cost of liquidation for 37 percent of the 1988 cases. The adjustments are sufficient to reduce aggregate cost savings through assisted acquisition from $7.2 billion to $0.3 billion. We must add that any estimates of either the cost of liquidation or acquisition are inherently imprecise, so that our results are only intended to be suggestive.

We also reviewed the sale of American Savings and Loan to the Bass Group. Again taking into account only those adjustments that are easily quantifiable, we estimated that the cost savings associated with that deal (estimated at $1.7 billion by FSLIC) were in fact negative. That is, the adjusted cost of acquisition exceeded the adjusted cost of liquidation.

Neither the FSLIC estimates nor our adjustments take into account social costs that might result from dislocations caused by liquidating thrifts. For example, we have not considered the costs associated with any unemployment of those currently employed by the insolvent thrifts. Perhaps when those social costs are considered, the decision to approve 86 acquisitions in 1988 may be justified. However, our estimates suggest that, for at least several cases, preservation of the thrifts may not have been justifiable on the grounds that assisted acquisitions were less costly than liquidation, at least before taking into account these social welfare issues.

A further point is relevant to the complexity of the assistance contracts. Complex contractual terms inevitably make it difficult for the government to measure the costs of assisted acquisition. That difficulty precludes the government from taking full advantage of the competitive bidding process. An alternative arrangement that permits the government to identify the highest bid more easily would mitigate concerns that (1) the least costly alternative is not always selected and (2) thrifts may not be placed in the hands of acquirers who are best able to maximize the thrift's franchise value. Such an arrangement was discussed in section IV.D.

Our analysis of the FSLIC methodology suggests that the estimated costs of assisted acquisition tend to be understated. If one assumes that FSLIC estimates of the cost of liquidation are sound, this raises the question of why liquidations were not undertaken more frequently. One possibility is that FSLIC tended to choose assisted acquisitions in 1988 because of its own cash flow constraints. FSLIC's borrowing authority was limited in 1988 and there are indications, even on the part of the District Banks, of a reluctance to accept FSLIC notes, given that the U.S. government has not explicitly indicated it will back such guarantees. In practice this means that FSLIC would have to accept the burden of interest expenses higher than those of the U.S. government, had it pursued an aggressive liquidation strategy.

If liquidity constraints on FSLIC were a critical determinant in the analysis, however, it begs the question of why the explicit methodology underlying the acquisition versus liquidation decision focused on comparisons of the cost of solution and the cost of liquidation that did not recognize such constraints. Explicit recognition of the cash constraint would entail an evaluation of the willingness of institutions to accept FSLIC notes and the impact of higher dollar levels on that willingness.

Further, if the relevant alternative to assisted acquisitions was to leave insolvent S&Ls in the "holding pattern," rather than to liquidate them, then the costs of that alternative must be considered. The key element in that cost is the rate of growth in the net worth deficit. Presumably a high rate of growth would justify assisted acquisition, but FSLIC's methodology does not makes those comparisons explicit.

The role of FSLIC cash and personnel constraints raises many broad issues, including the difficult question of what was the appropriate dialogue between the FHLBB and the Congress during 1988. These issues turn on many considerations, e.g., the role of the federal deficit and the impending change in the tax status of FSLIC assistance, that are beyond the scope of our report.

VI. EMPIRICAL EVIDENCE ON FSLIC's COST OF SOLUTION

There has been considerable public controversy and speculation surrounding several aspects of FSLIC's 1988 assisted acquisitions. In particular, people have been led to question whether the "December deals" and "Texas deals" were as cost-effective as other deals, and whether deals involving large tax considerations added to the total cost of resolving cases through acquisition. Precisely because of all the controversy, it is important to begin the process of confronting the speculation with empirical evidence.

In this section of the report, we analyze evidence on FSLIC's "cost of solution," i.e. their cost of assisted acquisition, to address the three questions above and some related issues. Due principally to data limitations imposed by the tight time constraints involved, we will only be able to generate a preliminary assessment of these issues. Additional data exist to expand the scope of this inquiry to address other questions of equal importance. We develop here a general methodology that could be expanded to encompass these further questions, and discuss how one would proceed given the necessary data.

The data used in this section of the report includes the cost of solution via acquisition (COS), cost of liquidation (COL), and tax benefits as estimated by FSLIC. As indicated in section V, those data are subject to considerable measurement error. However, despite the presence of error, such data should still reflect underlying economic phenomena. Moreover, under assumptions discussed later, the analysis can be structured so that any measurement error in the variables should not affect our inferences. Thus, measurement errors that could be quite important in the liquidation vs.

acquisition decision would not necessarily have any impact on the conclusions in this section.

The rest of this section is organized as follows. In subsection A, we discuss the four principle questions that we will be able to address, focusing on the aspects that have provoked public concern. We then discuss two related questions that current data allow us to address. In subsection B, we discuss a general methodology that allows an assessment of the issues. We then present the evidence and discuss its implications. In subsection C, we discuss fruitful directions for further research that can be addressed with additional available data.

A. THE QUESTIONS

The general question is whether total cost to the consolidated government of FSLIC's assisted acquisitions was minimized. As we have discussed earlier, an effective competitive bidding and evaluation process would tend to minimize such costs, but whether the bidding/evaluation process was effective is open toquestion.

The full set of terms of the acquisition agreements are inherently complex and hard to value. Certain terms, such as the yield subsidy and capital loss coverage, though valued in FSLIC's cost of solution (COS) analysis, have option-like features and incentive effects that produce a downward bias of uncertain size in their measured COS. The tax benefits, though part of the background considerations in the negotiation process, were not explicitly valued in FSLIC's COS analysis except in a few cases. Branching rights, warrants, profit sharing, regulatory forebearances were also generally not explicitly valued. Furthermore, the future cost impact of forebearances and acquirer's capital infusion with respect to the potential for future calls on FSLIC's deposit guarantees is not explicitly involved.

Given the inherent complexity in contract terms coupled with an incomplete valuation methodology, one cannot be certain either that the full cost of assisted acquisitions is in fact less than the full cost of liquidation or that the lowest full cost bid is the one chosen for the deal. This would be so even in the context of a bidding process that produces intense competition for the rights to acquire insolvent thrifts. It is precisely for those reasons that one would like to know whether FSLIC's bidding/evaluation process has produced solution costs that reflect those elements of the terms that are incompletely valued. Moreover, it may be that these complexities were magnified in the context of the Southwest Plan (SWP), which involved large consolidations of thrifts, or in the context of the "December deals," where there is a concern that deals were rushed to completion prior to the December 31, 1988, tax law change.

To get at these issues, one would ideally like to obtain an independent measure of the full cost of FSLIC deals, as well as the full cost of the competing bids that were not chosen and the full cost of liquidation. Such a study is beyond the scope of this report, although we could go a long way in principle toward such a goal with data available from FSLIC. Instead, we will present a comparative analysis of the 1988 deals, focusing on the varying features for which we were able to obtain data. Although such a comparative study cannot say whether specific deals were efficient or not, it can say whether observable features of the deals that were consummated produced systematically higher or lower measured costs to FSLIC and/or the consolidated government.

Given this context, we can now list the questions that we will be able to address, each supplemented with a brief discussion of the issue at stake.

Q1: Were the December deals systematically less cost-effective than non-December deals?

The key issue here is whether the apparent rush to complete tax related deals by the December 31 deadline, which created an exceptionally high case load in December, had adverse effects on their costs of solution. This could occur if there was a curtailment in bidding and negotiation procedures that would normally serve to contain costs, or if there was a short-circuiting of evaluation procedures that would normally tend to identify the lower cost bids. Moreover, evidence from private merger and acquisition markets generally shows that keeping a firm "in play" longer produces benefits in terms of higher prices for the sellers.

Q2: Were the SWP deals systematically less cost-effective than non-SWP deals?

The SWP deals were structured under a separate authority from other deals, which went through the normal merger and acquisition division channel (MAD). The SWP was designed to (1) consolidate several S&L's into single packages of relatively large size, (2) structure a streamlined set of procedures to enable expedited handling of the large scale problem and (3) utilize a new "standard terms" contract. With such a different institutional structure, questions naturally arise as to its effectiveness. Moreover, the sheer size and complexity of the Southwest problem may make cost minimization more difficult.

Q3: Was the size of the tax benefits accruing to the acquirers offset by lower costs of assisted acquisition?

In a competitive and effective bidding process the full price of an acquisition should include the tax benefits accruing to the successful acquirer. Thus, in cases in which the acquirer's share of tax benefits are large, competition should work to reduce dollar-for-dollar the cost of solution along other dimensions. However, since only some of those dimensions are costed out in FSLIC's COS analysis, the effect of the tax share to the acquirer may be less than dollar-for-dollar.

Q4: Is there evidence of a tradeoff between tax benefits rebated to FSLIC, and other forms of assistance to acquirers?

Under a consolidated government perspective, tax benefits accruing to FSLIC from assisted acquisitions are simply a means of reallocating resources from general tax revenues to FSLIC, and hence involve no overall resource cost or benefit. In this regard, FSLIC's share of the tax benefits is a substitute for congressionally provided direct capitalization. Since such tax benefits were explicitly legislated by Congress, one should probably not criticize FSLIC for pursuing such revenues. However, one could argue that pursuing such tax revenues does not absolve FSLIC from recognizing and accounting for the consolidated government effects in their overall cost assessment. Board Member White in December memoranda, in fact, advocated just such a consolidated perspective. According to this perspective, FSLIC in acquisition negotiations should not accept higher solution costs in exchange for a larger share of tax benefits. The tax benefits accruing to FSLIC do not represent benefits to the consolidated government, whereas higher costs of solution in fact represent costs to the consolidated government.

Q5: Were the costs of assisted acquisition generally higher or lower for the larger scale cases?

If because of scarcer funding and personnel resources, FSLIC devoted relatively more attention and effort to larger scale cases (measured, e.g., in terms of the size of the liability base), then one should expect the cost of solution to be lower in larger cases, other things equal. Alternatively, if large scale firms have more franchise value, due perhaps to core deposit premiums or larger marketing networks, then they would have lower costs of solution, other things equal. In either case, one would expect a negative relation between COS and liabilities.

Q6: Were the costs of assisted acquisition generally higher or lower, relative to liquidation, for the large problem cases?

If FSLIC devoted relatively more attention and effort to "large problem" cases (measured, e.g., in terms of the size of the cost of liquidation, COL), then one should expect COS to be related less than dollar-for-dollar to COL. That is, greater savings should be achieved by FSLIC for high COL firms. Alternatively, a less than dollar-for-dollar effect of COL on COS could reflect the methodology used by FSLIC to measure the two variables. Specificially, it could reflect a downward bias in COS that grows as COL gets larger (i.e., a bias that is a function of the size of the problem). Several of the issues discussed in section V could lead to that form of bias; insertion of COL into the regression can serve to control for bias and prevent it from affecting the coefficients on other variables.

The above six questions can be addressed with data available to us from FSLIC under current time constraints. Further data are also available that would allow us to answer additional questions of interest concerning the effects of contract terms (such as forebearances and warrants) that have not been part of FSLIC's explicit valuation methods, but which played roles in negotiations. Obtaining such data is a matter of systematically extracting measures of the variables of interest from summaries of the contract terms available in a case by case basis. Although we have had access to such data, compilation would require a significant additional investment of time.

B. DATA, METHODS, AND RESULTS

The data available to address the above questions were obtained with access to confidential sources compiled by FSLIC. FSLIC maintains these data as part of the process of evaluating and monitoring past and ongoing acquisitions. Variable definitions and sources are listed in Table VI-1. The variables were collected for all 88 cases resolved through assisted acquisition over the course of 1988. Certain data inconsistencies across sources or missing variables necessitated the omission of 5 cases, leaving a total of 83 cases.

Given that we are using data subject to measurement error, the potential impacts on our analysis should be considered. The impact varies, depending on the analysis. We will first present some preliminary analysis based on contingency tables. Measurement error should not be an issue there unless error in COS or COL is different for December deals or SWP deals.

The primary analysis is based on a regression model. In that model, the main concern would be measurement error in COS. Section V offered several reasons to suspect that the COS is understated. To the extent the understatement is larger for firms with larger COL, as is likely, there will be an impact on the interpretation of results pertaining to Question 6, as discussed above. There may also be some understatement that is constant across firms; however, errors in that form would have no impact on our inferences. Any remaining error could be problematic only if it is systematically related to variables in the model other than COL, and we are aware of no reason to suspect that.

Measurement error could also exist in the tax benefits variables. The potential impact of that form of error is discussed when we examine the regression results.

TABLE VI-1

VARIABLES USED IN THE EMPIRICAL ANALYSIS

Definition	Source
Cost of "Solution", i.e. the cost of assisted acquisition as measured by FSLIC (millions of dollars)	Case Resolutions As of Dec. 31, 1988 (MAD)
Cost of Liquidation as measured by FSLIC (millions of dollars)	Case Resolutions As of Dec. 31, 1988 (MAD)
Total liabilities (RAP) (millions of dollars)	Case Resolutions As of Dec. 31, 1988 (MAD)
Total assets (RAP) (millions of dollars)	Case Resolutions As of Dec. 31, 1988 (MAD)
Estimated tax benefits accruing to acquirer (millions of dollars)	"Tax Benefits Computations," Worksheets prepared by FAD
Estimated tax benefits accruing to FSLIC (millions of dollars)	"Tax Benefits Computations," Worksheets prepared by FAD

Our first analysis focuses only on the relative effects of the December deals and the Southwest Plan (SWP) using a contingency table (Table VI-2). In each cell we exhibit the average percentages by which cost of liquidation (COL) exceeds FSLIC's estimated cost of assisted acquisition (cost of solution, COS). We term this FSLIC's "percentage cost saving," which we calculated as (COL-COS)/COL for each case. Each cell then presents the average percentage cost savings across the cases in the cell. The conclusion that one would draw from this table is that there appears to be no December deal effect, but that there is a rather strong Southwest Plan effect, with percentage cost savings being considerably smaller in the SWP cases.

TABLE VI-2

PERCENTAGE COST SAVINGS: DECEMBER VS. NON-DECEMBER AND SWP VS. NON-SWP

	December	Other months
SWP	18% (4 cases)	13% (9 cases)
Other States	37% (27 cases)	36% (43 cases)

Before drawing hasty conclusions, however, concerning either the SWP or December deals, one should recognize that from the consolidated government perspective the cost of solution should reflect the tax benefits accruing to the acquirer. These tax benefits are not a cost to FSLIC, but do represent a cost to the U.S. taxpayer.

Taking into account the tax benefits produces a "percentage cost saving (tax-adjusted)," calculated as (COL-COS-TXA)/COL. In Table VI-3 below we present the mean tax-adjusted cost savings over the cases in the four cells.

TABLE VI-3

PERCENTAGE COST SAVINGS (TAX-ADJUSTED)
DECEMBER VS. NON-DECEMBER AND SWP VS. NON-SWP

	December	Other months
SWP	2% (4 cases)	11% (9 cases)
Other States	31% (27 cases)	33% (43 cases)

In one sense, Table VI-3 tells a story similar to Table VI-2. Specifically, the dominant effect is that the Southwest Plan involved lower cost savings. However, as a result of adding in acquirer tax benefits, it now appears that a December effect may be emerging through the December-SWP cell. However, with only four deals in that cell, strong inferences are to be avoided.

Two-way contingency tables are interesting, but are not designed to tell the broader story about the interactions among December, SWP, and tax effects. Moreover, they do not control for either the size of the deal or the size of the problem. Thus, to answer effectively all six questions at once one must turn to multiple regression methods.

To this end, we construct a regression model for FSLIC's measured cost of solution, COS. For each of the six questions, we have a single operationally determined variable designed to capture the effect at issue. In Table VI-4, we summarize the structure of the regression and the predicted results for the regression variable under certain hypotheses in order to provide a easy reference for evaluating the empirical results.

TABLE VI-4

REGRESSION MODEL TO ANSWER SIX
BASIC QUESTIONS CONCERNING 1988
ASSISTED ACQUISITIONS

Variable to be explained: COS [Cost of "solution" in millions of dollars]

Question	Variable	Description	Interpretation
Q1	DEC	Takes on value of 1 if deal took place in December, 0 otherwise	Coefficient should be positive if December deals had higher costs
Q2	SWP	takes on value of 1 if deal came under Southwest Plan, 0 otherwise	Coefficient should be positive if SWP deals had higher costs
Q3	TXA	Tax benefits granted to acquirer (See Table VI-1)	Coefficient should be -1.0, (i.e. a dollar-for-dollar tradeoff if tax benefits to acquirer are fully "priced" in COS
Q4	TXF	Tax benefits rebated to FSLIC (See Table VI-1)	Coefficient should be zero if FSLIC takes consolidated approach and does not trade off higher solution cost for a share of tax benefits
Q5	L	Liabilities, a measure of size (See Table VI-1)	Coefficient should be negative if cost savings through acquisition are greater for large-scale cases
Q6	COL	Cost of liquidation (See Table VI-1)	Coefficient should be less than 1.0, if cost savings are greater for larger problem cases.

In Table VI-3, we present the results of the regression model, again keyed into the six questions, estimated over two sets of data. The first includes all cases; the second excludes the Utley-Ford deal, which was the biggest tax deal, dwarfing all others in terms of benefits to the acquirer. The coefficients reported reveal the size of the effect of the regression variables on the cost of solution, while holding constant for the effects of the other variables. Thus, the coefficients reveal the specific and separate effect of each variable. The t-statistics, shown in brackets, measure the statistical significance of the coefficients. T-statistics above 2.0 (in absolute value) indicate that the odds are better than 20-to-1 (the level often used in scientific hypothesis testing) that the affect is significant.

The results in Table VI-3 are strong and in some cases perhaps surprising. We take each question one at a time and discuss the answer provided by the empirical analysis.

Q1: Were the December deals systematically less cost-effective than non-December deals?

The evidence from the full sample of cases suggests that the December deals were no more or less costly than other deals, once one holds the other factors constant. The estimated coefficient of 8.3 indicates that, after holding other factors constant, average solution costs for the December deals exceeded those for deals made during the balance of the year by $8.3 million. This effect is not significant, however.

TABLE VI-3

LINEAR REGRESSION ESTIMATES FOR COST OF SOLUTION:
1988 FSLIC RESOLUTIONS

Variable to be explained: COS

Question	Variable	All cases including Utley-Ford Coefficients (Standard errors) [t-statistics]	All Cases except Utley-Ford Coefficients (Standard errors) [t-statistics]
Q1:	DEC	8.3 (11.8) [0.7]	-3.3 (11.7) [-0.3]
Q2:	SWP	0.5 (21.0) [0.0]	-15.5 (20.4) [-0.8]
Q3:	TXA	-.40 (.10) [-3.9]	.13 .19 [0.7]
Q4:	TXF	.63 (.11) [5.7]	.57 (.11) [5.4]
Q5:	L	-.029 (.003) [-8.5]	-.032 (.003) [-9.5]
Q6:	COL	.87 (.02) [43.2]	.86 (.02) [45.9]
	N	83	82
	R^2	.996	.993

TECHNICAL NOTE: Regressions above were estimated by OLS. The residuals were heteroskedastic with respect to both DEC and SWP (but not COL or L). Correcting for this via Weighted Least Squares, using weights proportional to the residual variances for each of December and Southwest Plan cases, yielded estimated coefficients similar to those shown. The residuals exhibited some outliers (especially for SWP cases), but the results shown were reasonably robust to their deletion. Scaling all of the variables (DEC and SWP excepted) by COL, so that the dependent variable = % saving over liquidation, resulted in residual heteroskedasticity inversely proportional to COL. For this reason, we did not use a specification scaled by COL.

Q2: Were the Southwest Plan deals systematically less cost-effective than non-SWP deals?

Again the evidence from the full sample reveals no statistically significant cost difference for SWP and non-SWP deals. The estimated coefficient of 0.5 indicates that solution costs in SWP deals were higher, holding other factors constant, than non-SWP deals, but by less than $1 million. Since most SWP deals have solution costs in the range of $300 million to $2 billion, this effect is economically insignificant.

Note that our answers to questions (1) and (2) are not inconsistent with the suggestion in section V that it might have been less costly to liquidate some of thrifts that were preserved in acquisition. The above answers pertain not to the issue of whether acquisition was the least-cost option, but only to whether cost-effectiveness (or lack thereof) varied, according to whether acquisitions were December deals or Texas deals.

Q3: Were the size of the tax benefits accruing to acquirers offset by lower costs of solution?

The evidence from the full sample indicates that approximately 40 cents of every dollar of tax benefits granted to acquirers was returned to FSLIC in the form of lower costs of solution. However, this evidence of a tradeoff is entirely due to a single observation: the Utley-Ford deal. Thus, there is evidence of some (less than full) compensation received by FSLIC in Utley-Ford, the assisted acquisition that involved the largest transfer of tax benefits to an acquirer. When the Utley-Ford case is excluded from the sample, there is no evidence of a tradeoff between tax benefits for acquirers, and lower solution costs for FSLIC. (The coefficient on TXA is then insignificant and has the "wrong" sign.)

Evidence consistent with tax benefits not being priced is disturbing, in the sense that it calls into question how effective the bidding process was.

Under fully competitive bidding, tax benefits granted to acquirers should reduce FSLIC's cost of solution dollar-for-dollar, which would imply a coefficient of -1.0.

Thus, for the one deal which granted by far the largest tax break to the acquirer, FSLIC seems to have recaptured a significant fraction of the benefit in lower solution costs. But for the set of all the other important tax deals, many of which grant tax benefits of $50-$200 million to the acquirer, there is no evidence of an offset. One interpretation is that it wasn't until mid December, around the time of board member White's Lamb case memos, that a full appreciation of the consolidated government approach began to emerge at FSLIC, and taxes became an explicit issue. The Utley-Ford case then arrived as the largest tax deal, just as that awareness set in. In fact, the tax benefit data we used were calculated by FSLIC only in early 1989. (Preliminary tax benefit estimates were usually included with Board packages prior to December, but then estimates were generally lower than those produced in January.) An alternative explanation for why a coefficient of -1.0 is not observed is that when tax benefits were granted to an acquirer, either (i) FSLIC reduced others of assistance that were not part of the estimated costs of solution, e.g. forebearances, or (ii) FSLIC demanded other benefits in return (e.g. warrants). Whether such tradeoffs were made is an issue that could be addressed with further research.

Q4: Is there evidence of a tradeoff between tax benefits rebated to FSLIC, and other forms of assistance?

If FSLIC were taking a consolidated government view they would not try to effect such a tradeoff and the coefficient would be zero. Here the evidence indicates quite strongly that FSLIC did trade off greater FSLIC tax benefits for higher solution costs. The coefficient estimates of .63 in the full sample indicates that, for each dollar of tax benefits FSLIC rebated to FSLIC,

FSLIC permitted a 63 cent increase in the cost of solution. That leaves FSLIC better off by only 37 cents. However, from a consolidated government perspective a positive tradeoff is disturbing. Under that perspective, the 63 cent increase in cost of solution is relevant consolidated cost, but the one dollar tax rebate FSLIC provides no consolidated benefit. The magnitude of the impact on COS seems somewhat high to us and we would not be surprised to learn that further research aimed at controlling for more implicit characteristics of deals would reduce it. On the other hand, we should add that measurement error in TXF may bias our coefficient toward zero; if such is the case, then FSLIC may have reduced other forms of assistance dollar-for-dollar in return for tax benefit rebates. That would be even more disturbing than indicated above, from a consolidated government perspective.

> Q5: Were the costs of assisted acquisitions generally higher or lower for larger scale cases?

Here again the evidence strongly supports the hypothesis contained in the question. The negative coefficient on liabilities, L, is highly significant and robust. Other things equal, larger liabilities are related to lower costs of solution. One interpretation of this result is that FSLIC devoted more resources to the larger cases, enhancing cost-effectiveness as a result. An alternative interpretation is that FSLIC's costs are reduced for larger cases because FSLIC "sells" a larger core deposit premium to acquiring firms. Interestingly, the coefficient on L would suggest that the core premium is approximately 3 percent of liabilities, which is what is assumed in section V.

> Q6: Were the costs of assisted acquisitions generally higher or lower, relative to liquidation, for the large problem cases?

Measuring the size of the problem by the cost of liquidation (COL), the evidence reveals an effect of COL on COS that is significantly less than dollar-for-dollar. This means that for every dollar increase in the size of

the negative net worth hole, the solution costs increase by only about 90 cents. Under one interpretation, this represents a real savings of 10 cents through pursuit of the acquisition alternative as compared to liquidation. It would be consistent with FSLIC's devoting more effort to large problem cases and increasing cost savings accordingly. An alternative interpretation is that the savings are not real-- that COS is understated, relative to COL, with the understatement being larger for large problem cases.

One final issue emerges from the empirical results. One can ask not only whether on average there were December and/or SW Plan effects on the cost of solution, but also whether solution costs in December and SW Plan deals were more variable relative to other deals. It may be the case that the December "rush" and/or the complexity of the SW Plan caused more variability in the bidding, negotiation, and evaluation processes across deals with a resulting greater variance in solution cost outcomes, even if there is no effect on the average cost of solution. We can state this question as follows:

> Q7: Were the solution costs across December deals and/or SW Plan deals relatively more variable than the solution costs across deals in other months and states.

The regression used to evaluate Q1-Q6 allow us to answer this latter question. The explanatory variables in Table VI-3 produces a good "fit" in that they account for most of the variation in COS across the 1988 deals. However, as in every regression, the explanatory power is not complete and so there exists an unexplained or "residual" part of COS. The regressions reveal that across both December deals and SW Plan deals, the unexplained components of the costs of solution are significantly more variable than are the unexplained components across deals in other states and months.

C. CONCLUSIONS AND DIRECTIONS FOR FURTHER RESEARCH

We can now briefly summarize our empirical findings.

(1) We find no evidence that the costs of assisted acquisition were significantly higher for either the December deals or for the Southwest Plan deals. Thus neither the rush to complete deals before expiration of the tax breaks nor the special aspects of the SW Plan had adverse effects on FSLIC resolution costs. Note that this finding does not bear on the overall effectiveness of the 1988 acquisition programs; it indicates only that the degree of effectiveness was no different for December deals or Southwest Plan deals than for other deals.

(2) We do find, on the other hand, that the tax benefits accruing to acquirers were not generally offset by solution costs in the overall bidding process. Thus, the full cost to the consolidated government goes up essentially dollar for dollar with acquirer's tax benefits. Interestingly, however, there is evidence that in the Utley-Ford case, the largest tax deal by far, the acquirer's tax benefit share was offset approximately 40 cents on the dollar by lower solution costs.

(3) We find that FSLIC did trade off greater solution costs for a larger share of tax benefits. Since FSLIC's share of the tax benefits is not a net benefit from the consolidated government perspective, such a tradeoff raises the cost of solution to the consolidated government.

(4) Finally, we find that for both large-scale cases and large problem cases, FSLIC's estimated solution costs were lower, relative to its estimate of liquidation costs. This may indicate either that more effort was devoted to handling these cases, or may simply reflect the way FSLIC measured the costs of solution and liquidation.

We have been able to provide some empirical evidence on the key questions at stake in the current debate. There is much more research that could yield a better understanding of the resolution process. For example, in addition to tax benefits, there are several other terms of FSLIC negotiated agreements that are generally not treated explicitly in the formal cost evaluation procedure, but which play an important role in the negotiation process. Some of these include various regulatory forebearances, preferred stock, warrants, dividend and profit sharing, and branching rights. It would be of interest to be able to ask questions such as:

Q8: Did special regulatory forebearances affect the cost of solution?

Q9: Did cases in which FSLIC received warrants, preferred stocks, profit sharing and/or dividend sharing have higher solution costs?

Q10: Were branching rights implicitly "priced" in the deals, yielding reduced costs of solution?

To address questions such as these, we would need to obtain systematic data across all 1988 deals on the details of these special provisions. Such data are available in principle in the executive summaries to the "board packages" and could be compiled from such a source. Also available from the board packages are data on the number of bids and the characteristics of the bids not chosen. Such data would allow us to address questions such as:

Q11: Does the number of bidders affect cost of solution?

Q12: Do the costs of solution bear a relation to the "closeness" of competing bids?

Q13: Does an in-state preference or other ranking of acquirers affect costs of solution?

In addition to the above questions, it would be of interest to obtain more data on the characteristics of insolvent thrifts to see how those characteristics affect the costs of solution. Among the characteristics of interest would be "good" versus "bad" assets, brokered deposits, direct investment activity, core deposits, branch offices, employment, and G&A. It would also be of interest to undertake an analysis of the cases resolved through liquidation and relate these to various characteristics. Finally, it would be of interest to make the adjustments in COS discussed in Section V to see how an adjusted COS relates to the COS as currently measured, and to incorporate the adjusted COS into our empirical analysis.

VII. CONCLUSIONS

A. THE FUNDAMENTAL PROBLEM

The current crisis in the thrift industry is at least in part the consequence of a flawed deposit insurance system. The deposit insurance contract provides incentives for thrifts to bear risk, especially when they are thinly capitalized, because insurance premiums do not vary with risk.

Unless the underlying problem with the pricing of deposit insurance is dealt with as part of the solution to the current crisis, there will undoubtedly be future economic shocks that create future crises. Therefore, risk based premiums and higher capital requirements for high risk investments should be introduced as features of the insurance contract. Continued efforts by FSLIC to improve monitoring of asset risk are also appropriate.

B. FSLIC ESTIMATES OF THE COST OF SOLUTION THROUGH ASSISTED ACQUISISTION

Our analysis suggests that the costs borne by the government in assisted acquisitions may be substantially higher than that estimated by FSLIC. In many cases, the adjusted cost of assisted acquisition approaches or exceeds FSLIC estimates of the cost of liquidation. However, whether liquidation would in fact be a less costly option is a question that can be answered only after a more detailed analysis of the liquidation option.

C. ECONOMETRIC ANALYSIS OF THE COST OF ASSISTED ACQUISITIONS IN 1988

There has been considerable public controversy and speculation surrounding FSLIC's 1988 assisted acquisitions. In particular, some have questioned (i) whether the "December deals" and the "Texas deals" that were part of the Southwest Plan were less cost-effective than others, and (ii) what role tax benefits played in the pricing of assisted acquisitions.

Our preliminary econometric analysis finds no evidence that December and Texas deals were any more or less cost-effective than other 1988 assisted acquisitions, after holding constant the effects of tax benefits, the size of the thrift, and the cost of liquidation. However, the analysis also suggests that FSLIC may not have been compensated for tax benefits granted to acquirers, except for the single deal involving the largest tax benefits. Moreover, there are indications that FSLIC may have traded off other forms of assistance in order to obtain rebates of tax benefits. From a consolidated government perspective, this represents a net cost, since tax benefit rebates simply represent a transfer from one government agency to another.

D. A KEY RECOMMENDATION: THE "CLEAN ASSISTANCE PACKAGE"

The current forms of assistance packages should be replaced by a "Clean Assistance Package" that would attenuate many of the incentive and valuation problems inherent in current assistance packages and would streamline the negotiation process. A Clean Assistance Package would fix the contract terms for a thrift or group of thrifts prior to bidding. This does not require the use of the same contract terms across all acquisitions, but does require that the terms be fixed for a given acquisition. In addition, the package would (i) require that bidders make "all in" bids equal to the amount of assistance (in cash or notes) required to induce the acquirer to assume the assets and liabilities of an insolvent thrift, and (ii) rules out negotiation on the contract terms.

Regarding the contract terms themselves, the "clean" package would require acquirers to rebate 100 percent of tax benefits to FSLIC in order to eliminate the potential for valuation errors. The clean package would also exclude all forebearances and the granting of state branching rights as part of assisted acquisitions. Finally, the FHLBB would not receive warrants as part of any assisted acquisition agreement.

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Table 1:
INFORMATION ON 12 DEALS
(FSLIC - Supplied Data)
(millions)

TRANSACTION NAME (AND NUMBER OF THRIFTS)	ACQUIRED ASSETS	ACQUIRED LIABIL-ITIES	FSLIC ESTIMATED COST (CASH)		FSLIC ESTIMATED COST (PRESENT VALUE)		ACQUIRER CONTRI-BUTION	TAX BENEFIT TO FSLIC
			MERGER	LIQUIDA-TION	MERGER	LIQUIDA-TION		
SOUTHWEST PLAN								
Southwest Savings (4)	$3,998	$4,990	$3,521	$1,844	$1,980	$2,502	$25.0[a]	100%
Gibson (12)	2,217	3,193	2,379	1,166	1,314	1,546	48.0	100%
NuOlney (11)	3,750	4,300	2,293	1,041	1,287	1,668	80.0	60%
CFSB (15)	1,831	3,236	3,378	1,814	1,846	2,117	120.0	27%[b]
Utley/Ford (5)	12,006	13,026	8,908	6,281	5,046	6,822	315.0	28%[c]
Pacific (8)	854	1,151	987	530	566	662	37.5	25%
Centex (4)	323	649	813	417	429	464	26.5[d]	42%[e]
Hyperion (1)	4,400	4,700	2,200	1,111	1,372	1,492	200.0	42%[f]
NON SOUTHWEST PLAN								
D. P. Holdings (1)	954	1,407	696	600	566	700	20.0	0%
River Valley (3)	170	188	36	34	36	45	5.0	6%
First Nationwide[g] (4)	8,086	8,373	3,108	1,734	1,684	2,431	175.0	73%
Bass (1)	30,000	Not Available	Not Calculated		1,700	3,333	500.0	75%

[a] The acquirer did not contribute new capital. About $25 million in subordinated debt was converted to common stock.

[b] FSLIC is entitled to 33-1/3% of all tax benefits realized but is guaranteed minimum tax benefits of $11.1 m (NPV)

[c] FSLIC is entitled to 33-1/3% of all tax benefits realized calculated at a 30% tax rate. Assistance payments are tax effected on this basis but FSLIC is guaranteed a minimum of $30 m each year of the Agreement.

[d] $3.5 m of the $26.5 capital contribution represents the historical value of real estate.

[e] Negative Net Worth Note was reduced by $13.2 m as a prepayment of the estimated tax benefits due FSLIC for 1988; this amount is subject to adjustment after tax return is filed.

[f] Resulting entity will not generate sufficient taxable income to take advantage of most of the tax benefit items.

[g] Incorporating the asset backed transfer on December 9.

Source: FSLIC reported unaudited data.

The CHAIRMAN. Well, you have given us some very important conclusions, and I think we ought to try to open up some of the areas you raised in your summary. As you indicated, there is a detailed backup report which we've made a part of the record.

I'm concerned about the bidding process. I'm concerned about it looking backward because there's the appearance that it wasn't done perhaps the way it should have been done. I am concerned about it also in terms of how it ought to be done in the future.

I'd like you to go into as much more detail as you can on both the rationality and the fairness of the bidding process. I'm thinking in terms of looking for the soundest acquirer at the proper mix of financial circumstances, but also the fact that nobody got put ahead of somebody else in line or pushed behind somebody else in line or somebody got pushed out of the line. I am very, very concerned about that question and I want to understand exactly how it worked.

BIDDING PROCESS

Mr. BOWSHER. Well, it worked this way—but I also want to point out that there's not an awful lot of documentation on the bidding process so that as our people reviewed it we were limited by how much of the bidding proeess had actually been documented.

But the basic bidding process was that they requested interested parties—in other words, they sent notices out and they requested any interested party to come forward. Sometimes this was done on a blind basis. That means that they weren't told what institutions were up for sale at that point, just the fact that there would be institutions up for sale. And so they were to send their letters of interest in, which they did.

At that time, lots of times they had a large number. You could have 50 or 60 letters of interest. Then you go into the process of narrowing that down, and that's where the documentation gets fairly limited because you just don't know quite how sometimes—but they generally were looking for how much people would put in as capital, what was the management capability of the prospective groups, and they would narrow it down to maybe four or five. At that point, then, you would generally let those four or five people know what institutions they were really working on or packaging and asked would they be interested in this package.

Then at that point, they would eliminate some and that's where I think most of the people that were bidding on these deals felt like there was not good communication. In other words, we've talked to some people that were not successful and they said the phones just quit working, they weren't getting any information back. When they called in, nobody would be able to explain it.

Eventually, the Bank Board made a selection point. But as I say, lots of times there was really one bidder and FSLIC didn't go back out, as you would normally do in Government procurement, and ask for everybody to take another look at the final package. That's really the difference. In other words, that final package lots of times was really being bid by a relatively few bidders.

The CHAIRMAN. And I suppose the point is that once you've finalized what the package is going to be, if you really then have a competitive process, you're presumably going to get your highest dollar offer.

Mr. BOWSHER. That's right.

The CHAIRMAN. Because one person bids against another—presumably that brings in the maximum amount of money and decreases the amount that the Government will have to pay.

Mr. BOWSHER. I think the other thing, too, that is very important here is that actually many of the bidders were only bidding on statements that were provided. In other words, they were not allowed to go out and do due diligence, which is what you generally do in a situation like this, and find out what the assets and liabilities really are.

In fact, it's interesting in the one example we did use in this statement, the investor insisted on doing that and he found out that the thrift was insolvent. And so the thrift had to actually be put into the pool.

So what you've got here is, as I said at the very beginning of my testimony, you've got very preliminary numbers that we're all looking at and we really won't know what the real financial aspects of these deals are until the initial audits are done, which will be well on into this year.

The CHAIRMAN. Well, we intend to follow this through because I want to have the complete story before we're done because I believe in accountability and I want to know exactly what happened, however long it takes us to get the facts.

Now you say in your summary that between $7 and $8 billion in present value terms was used in the way of tax benefits. In other words, there was tax spending or the forgiveness of taxes of that amount in order to do these deals that were done in that short time period.

You also say that FSLIC did not take the costs of those tax benefits into account. They left those out in terms of valuing the cost of those deals. Is that right?

Mr. BOWSHER. When they did their analysis to determine whether the merger was less costly than the liquidation, they did not take them into account and that's the way the law reads, so they didn't have to.

Mr. FOGEL. They did, Senator, implicitly recognize in negotiating the deals that there would be some tax value to the acquirers, but they hadn't run any numbers. So in negotiating they tried to take that into account, but not explicitly.

The CHAIRMAN. But isn't it a cold fact that that $7 or $8 billion comes right out of the Federal Treasury?

Mr. BOWSHER. Oh, yes. That isn't in the first year. You have to understand that can come out——

The CHAIRMAN. I understand it's spread over a period of time.

Mr. BOWSHER. But the $7 to $8 billion is based on a present value basis.

The CHAIRMAN. So it's actually higher than that in terms of the actual dollars?

Mr. BOWSHER. Yes. Our best estimate is it could be over $10 billion on a cash flow basis that the Treasury might be giving up.

The CHAIRMAN. The fact that they weren't legally required to take that into account I don't think means much here. I think you are required to make a prudent financial decision and you're there to safeguard the assets of not just the savings and loan system but of the Federal Government. It's an arm of the Federal Government.

I find it very disturbing that the tax benefits in those amounts were given away. I want to come back specifically in my next round to the Perelman deal. I don't know what detail we have on that one, but I want to get into it specifically.

Senator Garn.

Senator **GARN** Thank you, Mr. Chairman.

I realize I'm treading on thin ice trying to make this balance without appearing to defend all the deals because I don't and I cannot. But going back into the context of my opening remarks, I would certainly agree, without even having looked at these myself, that undoubtedly we will find some where the cost of liquidation over time would be less than the deal that was made.

My question is, how could that be an option with the limited resources of FSLIC and the lack of willingness of Congress to provide those resources? I would suggest to you that if FSLIC had had the money, the easiest, quickest way to have solved this problem would have been to pay off the depositors, and liquidate those institutions that would have been more costly to keep open.

So in the case of certain S&L's, we would be able to say, "This one would have been better off liquidated. We can prove it. The future audit will prove it." The chairman is correct that we ought to follow through and answer these questions. It shouldn't have been done this way. It shouldn't have been bailed out—simply pay off the depositors, close it down, and get this brain-dead institution out of existence.

How could they do that without the resources? I mean, it's an academic option because you are now reviewing it and again I would agree it would be the better way to do it, but how could they do it with the resources they had available?

Mr. **BOWSHER**. Well, they had a couple of options, Senator, and that is they could have done what we're doing right now actually, and that is taking more control of the institutions. In other words, just like the FDIC is doing under the conservatorships. And still wait for the Congress to pass a legislative package that gave them real funds.

Senator **GARN**. Let me stop you there. Would you have confidence that Congress would do that in a reasonable amount of time with no plan from an administration like we now have from Bush? The first request was made by the previous administration in February 1986, nearly 3 years ago. If you were in that position, would you say, "I will take this over, depending on the Congress of the United States to give me some funds quickly to handle the situation," when there were 3 years of Congress not being willing to do that?

Mr. **BOWSHER**. Well, I think there was a major problem that the problem was not being recognized and I agree with you that the previous administration had not been willing to come up and agree to how large the problem was. But I really believe that moving forward on these deals here has obligated the Government and the taxpayers for billions and billions of dollars.

Senator **Garn**. Agreed. That isn't my question. That's obvious.

Mr. **Bowsher**. I would like to just say one other thing. That is, you could have also done many of these deals with more of a straightforward deal using some liquidation techniques even with the notes. In other words, without the cash. That was a very viable option.

Senator **Garn**. OK. Senator Proxmire and I, in August passed an amendment, for $11 billion of FSLIC notes, and full faith and credit, which is exactly what the Bank Board asked for, and Congress refused—the House refused to go along with that. We cut off another option of making that financing cheaper because we wouldn't explicitly place the full faith and credit behind those FSLIC notes.

Mr. **Wolf**. But in fact FSLIC did have the option to use notes and could have used notes to transfer deposits in these institutions to other organizations.

Senator **Garn**. Every time they used notes there were people, particularly in the House, criticizing the use of the notes.

Gentlemen, I'm not arguing with you that there wasn't a better way to do this. I'm just trying to put a little fairness in the debate. The chairman is right that we ought to investigate these S&L's. If we can save money the deals ought to be renegotiated. I don't disagree with any of that. I'd just like a little fairness in understanding the circumstances that existed in promoting these deals at that time and why.

Not that I'm arguing with you that we can't find some deals that could have been done better and renegotiate some of them if it can be done, but there seems to be no balance and no recognition of the restraints.

I happened to be in the middle of all of that. I wish we had approved $11 billion of FSLIC notes making them cheaper and making that a better avenue to go to. I still think we made a mistake there.

Mr. **Bowsher**. I think you have a sense, Senator Garn, that we haven't talked about the notes instead of cash. We did that in previous GAO reports and we recognize that having a package that includes real money would have helped tremendously and we really think that's what's needed now, that's the legislative package that the Bush administration has sent over. So when we were doing this report we were asked to look at these deals and that's why we explicitly did that.

The other thing too I might point out, Senator, and that is I haven't always been here at GAO. I've been on the other side of the table. I've been involved in the Chrysler and Penn Central and the Lockheed deals and we always tried to get our reforms up front and we waited for that legislation sometimes worrying that we were waiting too long, but I really think when you move ahead of that and do deals like this you just get committed for so much money because that's the only deal you can generally work out with some of these people. So that's why I think it's important now that if the legislation passes that the new corporation go back and review these deals.

Senator **Garn**. Well, I don't disagree with that. That was not my point.

One quick question. My time is up. You are FSLIC's independent auditor, aren't you, GAO?

Mr. BOWSHER. That's correct.

Senator GARN. And a year ago I believe you testified that the problem was a $35 billion problem.

Mr. WOLF. $35 to $42 billion.

Mr. BOWSHER. I think that's about right.

Senator GARN. Well, I only make the point then in hindsight you were terribly wrong a year ago just like FSLIC was then.

Mr. BOWSHER. Well, let me put that in context.

Senator GARN. That's all I was trying to do is put this other in some context. I would be happy to allow you to put it in context.

Mr. BOWSHER. Well, for the last 3 years we have been trying to get people to recognize that this is a very, very serious problem and that the dollars were escalating. Every time we tried to show how large the reserves would be, we got tremendous pressure. We didn't respond to those pressures. We were giving our best estimates at the time. But there was no question it was deteriorating. It was deteriorating very fast.

I think that one of our great problems was that some of the leadership at the Federal Home Loan Bank Board did not want to recognize that there was a problem of that magnitude. They agreed there was a problem, but they just thought—and I can remember when we were asked even to reverse our reserve of the previous year and of course we did not. We actually added to that loss reserve. So we have tried to be like that and you're right, we have not been—probably when you look back on the record where our numbers were as large as probably what they should have been at that point, but I think if there is any organization in the Government that was trying to get this problem out on the table and showing that it was increasing at a fairly rapid and dramatic rate, I think it was us.

Senator GARN. Well, I agree, but my point was, in hindsight, you were dramatically low, like everybody else was, but this Senator was not one of those putting pressure on you.

Mr. BOWSHER. That's correct.

Senator GARN. You may remember I was the one that was using 3 years ago your estimate of $6 million a day lost trying to get the FSLIC recap passed in 1986. By the time we got to October 1986, your estimate was $10 million a day and I was giving speeches all over this town and all over this country using your $6 to $10 million a day increase trying to get that passed. So there were some 3 years ago who were not taking your estimates lightly.

Mr. BOWSHER. Yes, there were.

Senator GARN. Thank you, Mr. Chairman. My time is up.

The CHAIRMAN. Thank you, Senator Garn.

Senator Bryan.

Senator BRYAN. Thank you, Mr. Chairman.

Mr. Bowsher, you're indicating that the RTC should go back and look at some of these acquisitions and I guess my question is, I certainly agree with that, but what can we accomplish? Is there a basis from what you've been able to observe that by reexamining some of these transactions that they are permeated with fraud or overreaching so that we can in effect unwind them, rescind them, and go back to a better plan in terms of taxpayers' dollars? What can we do after we've reviewed these?

REEXAMINING SOME OF THE TRANSACTIONS

Mr. **Bowsher**. You basically have two options. That's prepayment of the negative net worth notes. That's the notes that you give for the difference between the assets and the liabilities. And then purchase of the guaranteed assets. I know that Bill Seidman has testified, differently, that maybe you can even get out of the deal entirely. Our lawyers don't think so. And so what we see is looking at the provisions in the deals and what could the Government do, once they have funds, to actually prepay notes and then purchase assets.

Senator **Bryan**. So if I understand your testimony, you're saying in effect, without setting aside the transaction, without rescinding it, within the structure that was put together there are a couple of options that may be less costly in the long run?

Mr. **Bowsher**. That's right, because many of these contracts last up to 10 years. That's one of the things that worries everyone. So the idea is that once we get funds, once we get some cash, then maybe you can go in and mitigate some of these costs.

Senator **Bryan**. Is there any justification for the rather bizarre bidding procedures? I mean, this notion that you bid into a blind transaction and you don't even know the savings and loans that you might be acquiring, that strikes me as rather astonishing. Is there any justification for that?

Mr. **Bowsher**. I think it's hard to justify because I think everything in the Government has to be done on as fair a basis as possible when you're dealing in these large, what I call, procurements, and in this case I'm sure they were overworked. I'm sure they were understaffed. So I think that's probably the justification. Dick, you probably have talked to some of those people.

Mr. **Fogel**. Senator, when the FSLIC and Bank Board staff were trying to look at the Southwest deals, one of their concerns was that there were so many insolvent thrifts they weren't sure which packages to put together. And it was, as we say in the testimony, a very fluid process and the first thing they tried to do was just to find out whether investors were even interested in buying some. They didn't tell them which ones. They didn't tell them which packages. So they wanted to see whether it was even possible to put some of these deals together.

That's why they asked for the blind bidding, if you will. One of the problems, though, was it wasn't blind to everyone because they were out trying to see whether some of these deals could be put together. So it was a very confusing, very fluid process that changed constantly. As an investor would come in, an investor would say, "Well, I'd like to bid on these four thrifts," and maybe they were in one package, and they'd say, "Well, let's put them maybe in another package and let you bid on that." So not everyone knew and had the same information.

Part of the problem was that you had so many insolvent thrifts down there they were trying to see which types of packages would sell and attract the most capital, although most of them didn't attract much capital anyway.

Senator Bryan. Did anything in your investigation of these transactions suggest to you that we are dealing here with anything more than people that were overworked, exercised poor judgment? Does any of this rise to the level that would invite your suspicion that there was complicity, that there was an element of fraud?

Mr. Bowsher. No, I don't think so, Senator. There might be some of that, but we didn't discover it. I mean, the process was so loose that there obviously could have been some insider knowledge come into play and things like that, but we did not discover it, and our type of review probably wouldn't discover it.

Senator Bryan. We have been told previously that the package consists of $40 billion for the resolutions through calendar year 1988, the $50 billion zero coupon bonds and the $24 billion in the future. Your testimony seems to suggest that that $40 billion piece through year end may be seriously below realistic projections. We had some rather fancy footwork here. I think the chairman described it as a Michael Jordan move to the basket when we were asking the question whether or not that $40 billion includes the tax benefits. I'm not sure we ever got an answer. Maybe you could help us out on that.

Mr. Bowsher. No, it does not include the tax benefits and we think also you've got to keep in mind that the $38 billion, which is the $40 billion, is on a present value basis. Our best estimate is that on a cash flow basis that's going to cost about $60 billion.

Mr. Fogel. And the other thing that's very important to reemphasize again is that's only the estimated costs because once you go in and do an audit, if history is prolog, what they will find is that the assets aren't worth as much as they thought when they went into these deals. That's the indication so far. So it's going to end up costing FSLIC and therefore the Government even more than we now estimate just to provide the funds to cover all of the deals that were done in 1988.

That gets to the point of what could we do differently in the future. One of the things that needs to be done is that both the Government and the investors need to have a better picture of the financial condition of the institutions before they begin the negotiation process.

Senator Bryan. You mean a better understanding of the acquiring institution or the acquired institution?

Mr. Fogel. The acquired institution. In this situation, a lot of the investors had no idea of the financial condition of these institutions before they were asked to put in bids on them. If you're going to try to have a more orderly process, you want to have a process which, in the parlance of the Bank Board and FSLIC, is called due diligence reviews done so you know the financial condition of the institutions that are going to be acquired.

Mr. Bowsher. That's going to be done after the fact now.

Senator Bryan. Mr. Chairman, my time is up.

The Chairman. Thank you, Senator Bryan. I hope we can pursue that a little bit later.

Senator Bond.

Senator Bond. Thank you, Mr. Chairman.

Mr. Bowsher, to follow up on the thoughts I expressed in my opening remarks, I wonder if you can give us an objective way to figure out just how much the thrift industry can afford to pay to recapitalize the insurance fund. We're asking them also, in order to make the industry healthy, to build up capital to 6 percent, to write off their good will, and there's a provision that premiums could go up to 35 basis points.

We have heard some howls that the industry can't do all those things. Can you give us a formula or a basis to evaluate just what the maximum we can do would be to achieve all of those goals?

RECAPITALIZATION OF THE INSURANCE FUNDS

Mr. **Bowsher**. Well, we have looked at it and our best thinking right now is that the legislative package that came over from the administration probably has a pretty good balance there. I think normally in these bailout situations and in the lessons learned—the book that we put out a couple years back—one of the things we said is everybody has got to make a contribution to one of these things. Like in the Chrysler case, you remember, Mr. Chairman, we asked the suppliers, we asked the State, we asked the unions. In the financial institutions it's somewhat of a different situation because you're really paying off the depositors and then now you're trying to structure it so that you don't push a lot of the healthy S&L's into the insolvent group. In other words, if we extract too much from them in premium payments and everything like that, what we could do is push another group of 50 or 100 into insolvency down the road.

What I think the administration proposal has done is the right thing. They are told to get the accounting straightened out. Get rid of this goodwill that's on there. Let's get the capital up to a decent level. And here's the premium that's going to have to be paid to rebuild.

We think that's about the right package ourselves. We don't have any better information I'd say that would add or deduct from that.

Mr. **Wolf**. There's one thing that frankly we and others have surfaced and that needs to be looked at. That's the provision to go beyond the 23 up to I believe it's 35 basis points under some criteria. If that's done right away at the very beginning of this whole process, I think our sense is that might be the step that goes too far. You might want to take a look with the Treasury people and others at whether you want to put some kind of a timeframe that says that will not occur prior to such and such a year, so that you give the industry some opportunity to build up its capital without right away facing a much higher rate of premiums. I don't have any specific number. It's just an area where I think you want to take a look and it seems to be sort of the sensitivity point in their whole calculation.

Senator **Bond**. Mr. Bowsher, your comments reminded me of the old story of the chicken and the pig debating about whether to go in and have bacon and eggs for breakfast and the chicken is all for it. The pig says, "For you it may be a contribution. For me it's a total commitment." [Laughter.]

We want to be able to continue to get eggs without sacrificing the animal.

So you're telling us that you are comfortable with the numbers.

Mr. BOWSHER. Yes.

Senator BOND. So long as we put some time limitation on the speed at which it could go to 35 basis points?

Mr. BOWSHER. That's right.

Senator BOND. Next you discuss the lack of incentives to manage properly the assets covered in the December deal. What kind of advice could you give to those running the Resolution Trust Corporation in managing all the assets that will have to be dealt with as the thrift cleanup proceeds?

Mr. BOWSHER. Well, I think what you want to do there is look more to the example of how the FDIC does it, which is to try to encourage the moving of the assets you might say, and I think here what we've done is we've given incentives to hold the assets for a long period of time. There's no question that what you've got to do is be careful in each area as to how many assets are put on the market at any one time because you don't want to depress the real estate market to where it just drives everything down to nothing. So it's a very tricky thing, but what we do believe is that some of the techniques and some of the incentives that the FDIC has used over the years are something that they ought to look at and I think they're planning to look at if the administration bill goes through.

Senator BOND. Do you agree that marketing at a fair and open auction process is a good way to resolve some of the thrift problems if you can get a better return than on liquidation?

Mr. BOWSHER. That's right. I don't think you have to go straight to liquidation.

Senator BOND. Do you have any suggestions that we might incorporate on how to market those?

Mr. BOWSHER. Well, again, I think actually the way the FDIC has done it over the years is a pretty good way of doing it. In other words, they go in and they do the due diligence. They find out what the assets and the liabilities really are. They know then what the package is all about and then they talk to some potential buyers. So I think that's the way to do it.

Senator BOND. Thank you, Mr. Bowsher.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bond.

Senator Graham of Florida.

Senator GRAHAM. Thank you, Mr. Chairman.

Mr. Bowsher, I'm looking at table 1 at the back of your statement. I was interested in the columns that refer to the FSLIC estimated cost, one on a cash basis and the other on a present value basis of dealing with the issue through merger or liquidation.

Just focusing on the cash column, although I think the same conclusion would be true also at present value, it appears that this analysis indicates that it was less expensive in every case cited to have dealt with the problem through a liquidation rather than a merger. Is that correct?

Mr. BOWSHER. That's right, on a cash basis.

Senator GRAHAM. You had indicated that your analysis was that in ⅓ of the cases it would have been. That was based on a present value analysis?

Mr. BOWSHER. Yes. That was present value analysis plus the tax benefit analysis.

Mr. FOGEL. That's the key thing, Senator. The FSLIC does not legally have to take into account the tax benefits in deciding whether it's cheaper to merge or liquidate.

Senator GRAHAM. So in their calculations the tax benefits are not an included factor, is that correct?

Mr. FOGEL. That's correct.

Senator GRAHAM. I note moving to the two left vertical columns of numbers that the acquired assets versus the acquired liabilities difference is substantially less than the cash estimate of liquidation. For instance, the first one, Southwest, the difference between acquired assets and acquired liabilities is approximately $1 billion, yet the acquired cash liquidation is $1.844 billion. What contributes to that difference?

Mr. WOLF. There are a couple of things that contribute to the difference. In addition to a note to make up the underwater or the below book value values there, you've got interest on all of those notes, which is included in the cash computation. You've got a provision to provide capital loss coverage. In other words, if they sell the asset at below book value, we will reimburse it, and you have a guaranteed profit.

Senator GRAHAM. So what you're saying is those acquired assets, that's the book value of the assets?

Mr. BOWSHER. Yes.

Senator GRAHAM. So part of that, in the case of Southwest Savings, the $1.844 billion, is an anticipated write-down of those assets?

Mr. WOLF. It's a write-down that's been taken, yes.

Mr. BOWSHER. Yes.

Senator GRAHAM. In the press today there was an article that the Treasury was going to be recommending a disposition process, the general outlines of which would be some form of a trust on a State-by-State basis supported by——

Mr. BOWSHER. Is this the McNamar plan?

Senator GRAHAM. I don't know whose name is attached to it.

Mr. FOGEL. A former Treasury official recommended it, not current Treasury people.

Senator GRAHAM. A person.

The CHAIRMAN. Former as of what, 60 days ago or 40 days ago?

Senator GRAHAM. Do you know enough about that plan to evaluate it?

Mr. BOWSHER. No. We have not reviewed that plan at all. We read about it in the paper today for the first time.

Senator GRAHAM. Do you believe that such a plan would likely have the effect on a present value basis of increasing or decreasing the estimated value of assets from that upon which this FSLIC analysis was conducted?

Mr. **Bowsher**. I don't think we can really comment because we really don't understand all the details in that plan. I think what can happen is with the present legislation you're going to set up this corporation and then I think they could look at the various alternatives of different organizations to help them. But I don't think today that we could make any judgment on whether this plan would make sense or not. But that would be one of the things I think the corporation, those three directors that have been put into the legislation, they could evaluate at that time. I don't think it's absolutely necessary to go to that, though. I think, again, that's a private sector arrangement to try to work out. You can do that several different ways. In other words, that's just one of many plans that I would think would be submitted to the corporation by private sector people trying to be part of the act you might say and be of assistance.

Senator **Graham**. I would be interested in your evaluation as this process moves forward of various proposals that I anticipate will be made relative to congressional standards for disposition of assets in the context of what those proposals would likely do to the estimate of liquidation value from which you are presently operating and whether they would tend to depress or enhance the value.

Mr. **Bowsher**. One thing we might point out, Senator, is that we have issued a report on FADA which gets into many of the issues on disposing of the assets and many of the options in that. So we will send over to your office a copy of this, but then we will follow up, too.

The **Chairman**. Let me correct the record. I was in error a moment ago. Mr. McNamar left the Treasury Department some years ago, apparently when Don Regan left.

Second, we had a bit of a dispute this morning as to whether a piece of information that you had developed, a summary table comparing several of these assisted transactions, could be made public. There was an initial reservation by the Federal Home Loan Bank Board. But we've resolved that, so that information is properly public information. We are reproducing it now and it will be available to the press and others as soon as we have enough copies to distribute.

[The following information was subsequently submitted for the record:]

TABLE 1

Gain and Loss Sharing Provisions
On Covered Assets

ACQUIRER	LOSS SHARING BY ACQUIRER	GAIN SHARING BY ACQUIRER
Southwest	None	Acquirer - 10% of gains over original book value for first $25 million of gains; increasing by 2% increments for each $25 million of gains thereafter up to 20% share gains.
Gibson	50% of losses measured against original book value (with all reserves reversed), reduced by 50%, during the first three years; subject to an overall limit of the Acquirer's net income after tax for the period.	50% of gains measured against original book value (with all original reserves reversed) reduced by 50% until the Gain Sharing limit is reached, and therefore 25%. REO gains are measured against 50% of book value, without reversal of any reserves or write downs. The Gain Sharing limit measures all gains shared by the Acquirer against a varying percentage of the Acquirer's Cash Contribution as follows: Year — Percentage 1-3 — 75% 4-5 — 100% 6-8 — 135% 9-10 — 150%

TABLE 1

Gain and Loss Sharing Provisions On Covered Assets

ACQUIRER	LOSS SHARING BY ACQUIRER	GAIN SHARING BY ACQUIRER
NuOlney	None	The acquirer will receive 10 percent of any gains over the adjusted book value (book value less reserves) realized on the disposition of covered assets for the first $25 million of gains. The acquirer's portion of the gains will increase by increments of two percent for each additional $25 million of gains thereafter, up to a maximum of 20 percent. FSLIC will receive 50 percent of any gains over book value on the dispositon of these assets. FSLIC will not participate in any gains on the disposition of the uncovered assets of the other acquired institutions.
CFSB	None	Adjusted Book Value defined to be 80% of Original Book Value for each asset. Ten percent (10%) of gains over Adjusted Book Value on an asset-by-asset basis for the first $15,000,000 of cumulative gains, increasing by two percent increments for each additional $10,000,000 in cumulative gains not to exceed 20%

TABLE 1

Gain and Loss Sharing Provisions On Covered Assets

<table>
<tr><th>ACQUIRER</th><th>LOSS SHARING BY ACQUIRER</th><th>GAIN SHARING BY ACQUIRER</th></tr>
<tr><td>Ultley/Ford</td><td>None</td><td>The acquirer will receive a percentage of the proceeds received from the disposition of each covered asset when the proceeds received exceed 50% of gross book value. The acquirer's portion of the gains will increase as the aggregate dollar amount of proceeds received in excess of the 50% of gross book value increases as follows:
<table>
<tr><th>AGG. PROCEEDS IN EXCESS OF 50% OF GROSS BOOK VALUE ($ IN MILLS)</th><th>PERCENT TO ACQUIRER</th></tr>
<tr><td>UP TO $200</td><td>10</td></tr>
<tr><td>$200 UP TO $250</td><td>12</td></tr>
<tr><td>$250 UP TO $300</td><td>14</td></tr>
<tr><td>$300 UP TO $350</td><td>16</td></tr>
<tr><td>$350 UP TO $400</td><td>18</td></tr>
<tr><td>MORE THAN $400</td><td>20</td></tr>
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TABLE 1

Gain and Loss Sharing Provisions
On Covered Assets

<table>
<tr><th>ACQUIRER</th><th>LOSS SHARING BY ACQUIRER</th><th>GAIN SHARING BY ACQUIRER</th></tr>
<tr><td>Pacific</td><td>The acquirer will share the following percentages of losses based on the adjusted book value of such assets, provided that the cumulative amount of losses assumed by the acquirer does not exceed the cumulative amount of gains allocated to the acquirer.
Yrs. 1-3 10 percent
Yrs. 4-5 15 percent
Yrs. 6-7 20 percent
Yrs. 8-10 30 percent</td><td>The acquirer will share the following percentages of gains based on the adjusted book value of such assets:
Yrs. 1-2 45 percent
Yrs. 3-5 40 percent
Yr. 6 20 percent
Yrs. 7-10 10 percent</td></tr>
<tr><td></td><td colspan="2">The acquirer shall not share any gains or losses on assets whose original book value is less than $500,000. The FSLIC assumed that no gains were realized upon the disposition of the covered assets. Therefore, since the acquirer is not projected to receive any gains, the acquirer would not assume any losses.</td></tr>
<tr><td>Centex</td><td>None</td><td>Any gain received over book value (with all reserves reversed) will be shared as follows:
The first 10 percent gain will be shared 80% to FSLIC and 20% to Centex, the second ten percent gain will be shared 70% to FSLIC and 30% to Centex; and any remaining gain will be shared 60% to FSLIC and 40% to Centex.</td></tr>
</table>

TABLE 1

Gain and Loss Sharing Provisions On Covered Assets

ACQUIRER	LOSS SHARING BY ACQUIRER	GAIN SHARING BY ACQUIRER
Hyperion	The acquirer absorbs 5 percent of the amount, if any, by which the Fair Market Value as of the Effective Date of an asset in categories I and II exceeds the Net Proceeds Received by the acquiror, and 10 percent of the amount, if any, by which the Adjusted Book Value of assets in categories III, IV, and V exceeds the Net Proceeds Received.	FSLIC will receive 90% and Acquirer 10% of all gains over gross book value.
D P Holdings	-Term of five years -Based on net book value -FSLIC covers 80% of the loss -Acquirers 20% share is capped at $35 million -"Covered Assets" include: -exhibit 6 of proposal -Mortgage and Non-Mortgage loans greater than 90 days delinquent or become 90 days delinquent within 3 years, excluding 1st and 2nd mortgates on single family less than $500,000.	FSLIC receives 80% of gain

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Gain and Loss Sharing Provisions
On Covered Assets

ACQUIRER	LOSS SHARING BY ACQUIRER	GAIN SHARING BY ACQUIRER
River Valley	Ninety percent of the amount: (1) by which the Book Value of a Covered Asset exceeds the Net Proceeds Received by RIVER VALLEY upon the liquidation of such Covered Asset; or (2) of any write-down Covered Asset approved by the CORPORATION.	Ninety percent of the amount: (1) by which the Net Proceeds Received by RIVER VALLEY upon the Liquidation of any Covered Asset exceeds the Book Value of such Covered Assets; or (2) by which the Net Proceeds Received exceeds the Book Value as written down, if such Book Value has been written down with the CORPORATION's permission as provided.
First Nationwide	None	First Nationwide receives 10% of gains after tax for Cardinal and Pathway and 20% for Columbia/Mile High. First Nationwide also gets 10% of net proceeds received that exceed 80% of net book value as an incentive fee.
Bass	None	If the proceeds are greater that the adjusted net book value at sale then AREG receives an incentive fee of approximately 10% of the excess.

Source: Compiled by GAO from Federal Home Loan Bank Board documents.

Table 2:

RESTRICTIONS ON PAYMENT OF DIVIDENDS CONTAINED IN ASSISTANCE AGREEMENTS FOR 12 FSLIC TRANSACTIONS

No dividend limitations apply to insured thrift institutions which meet their fully phased-in capital requirement. Those not meeting this requirement which are owned by a holding company are limited to paying out dividends no more than 50% of net income. All other thrifts not meeting this requirement cannot pay any dividends. However, exceptions can be granted by the FHLBB on a case-by-case basis.

Dividends allowed in the 12 assistance agreements are as follows:

Southwest	No dividends as long as FSLIC owns preferred stock.
Gibson	50% net income, except more with approval of PSA and ORAS. Cannot pay a dividend if it reduces regulatory capital below forbearance requirement.
NuOlney	50% net income if regulatory capital is at least 1.5% of total liabilities; increasing by .3% in year 2; .4% years 3-5; .5% years 6-9, 1% in year 10.
CFSB	Consolidated S&L will be permitted to pay up to 50% of net income in dividends if the institution meets its capital schedule.
Utley/Ford	Up to 50% of net income may be paid in dividends if the institution is meeting its capital schedule.
Pacific	Up to 50% of its net income for a fiscal year, provided that the institution's level of regulatory capital following payment of such dividend is no less than the regulatory capital set forth in its capital schedule.
Centex	Up to 50% of net income in dividends on its common stock if the institution is meeting its capital schedule. Also may pay dividends on preferred stock to be issued in an amount up to 75% of net income if, following the payment, the institution would maintain a level of regulatory capital equal to .75% above the capital schedule.
Hyperion	50% of net income provided that, following the payment, the level of RAP CAP is no less than the lesser of its fully phased in requirement or a level .5% above the capital schedule.

River Valley	No limits other than regulatory standards (exclude FSLIC cash contribution from regulatory capital when determining whether and when to pay dividends).
D.P. Holdings	No limits other than 50% of GAAP income.
First Nationwide	50% of net income if the institution meets its minimum capital requirements; 75% if the capital ratio is between 6% and 8% of liabilities; 100% if the capital ratio is over 8%; after giving effect to such declaration.
Bass	No provisions limiting dividends were found in documents provided by the Bank Board. Thus regulatory standards would apply.

Source: Compiled by GAO from information obtained from Federal Home Loan Bank Board.

Table 3:

FSLIC-GUARANTEED YIELD ON COVERED ASSETS FOR 12 TRANSACTIONS
(Numbers added to TCF, TBR and COF are in basis points, with 100 basis points equal to one percent)

Transaction	Ten Year Period Following Effective Dates of Transactions									
	1	2	3	4	5	6	7	8	9	10
Southwest Savings	TCF+275	TCF+250	TCF+250	TCF+225	TCF+225	TCF+200	TCF+200	TCF+200	TCF+200	TCF+200
Gibson [a]	TCF+275	TCF+262 to 270	TCF+249 to 265	TCF+237 to 250	TCF+224 to 250	TCF+211 to 250	TCF+198 to 225	TCF+186 to 225	TCF+173 to 200	TCF+160 to 175
NuOlney [b]	TCF+220 to 250	TCF+220 to 250	TCF+185 to 215	TCF+175 to 205	TCF+170 to 200	TCF+160 to 190	TCF+150 to 180	TCF+140 to 170	TCF+130 to 160	TCF+120 to 150
CFSB	TCF+235	TCF+233	TCF+228	TCF+223	TCF+218	TCF+209	TCF+200	TCF+191	TCF+182	TCF+173
Utley Ford [c]	TCF+225	TCF+220	TCF+215	TCF+210	TCF+205	TCF+200	TCF+190	TCF+180	TCF+165	TCF+150
Pacific	TCF+260	TCF+260	TCF+250	TCF+245	TCF+235	TCF+225	TCF+215	TCF+205	TCF+195	TCF+185
Centex [d]	TCF+250	TCF+250	TCF+225	TCF+225	TCF+200	TCF+200	TCF+190	TCF+175	TCF+150	TCF+150
Hyperion [e]	TCF+220	TCF+210 to 220	TCF+205 to 210	TCF+200 to 205	TCF+195 to 200	TCF+190 to 195	TCF+185 to 190	TCF+180	TCF+180	TCF+180
River Valley [f]	NONE	NONE	NONE	NONE	NONE	NONE	NONE	NONE	NONE	NONE
DP Holdings	TBR+250	TBR+225	TBR+200	TBR+175	TBR+150	NONE	NONE	NONE	NONE	NONE
First Nationwide [g]	COF+275	COF+250	COF+225	COF+200	COF+200	COF+175	COF+175	COF+150	COF+150	COF+150
Bass Group [h]	NONE	NONE	NONE	NONE	NONE	NONE	NONE	NONE	NONE	NONE

Abbreviations

TCF = Texas Cost of Funds, that is, the average cost of funds of all FSLIC-insured institutions in the State of Texas.
TBR = The 1-year Treasury Bill Rate, quoted on a bond equivalent basis.
COF = The average Cost Of Funds of all FSLIC-insured institutions located in the District of the FHLB of Topeka.

SOURCE: Compiled by GAO from information obtained from the Federal Home Loan Bank Board.

Notes for Table 3

[a] Two schedules of declining guaranteed yields are specified. The higher schedule applies at any time when the gain sharing limit on covered assets has not been reached; the lower schedule applies at all other times.

[b] Covered assets are divided into 2 groups. Group 1 assets have a 5-year term and group 2 assets have a 10-year term. Categories of assets within each of the 2 groups have levels of guaranteed yields within the ranges shown.

[c] The term of yield maintenance per asset category is as follows:

1-4 Residential Covered	2 Years
5 or more Dwellings Units	5 Years
Commercial Loans	3 Years
Consumer Loans	None
Consumer Financing Leases	None
Non-Investment Grade Securities	None
All Other Covered Assets	10 Years

[d] If 50% of the covered assets have not been sold or otherwise disposed of by the end of the sixth year, the guaranteed yield rate for year 7 will be reduced to TCF + 160 basis points.

If 60% of the covered assets have not been sold or otherwise disposed of by the end of the seventh year, the guaranteed yield rate for year 8 will be reduced to TCF + 135 basis points.

If 70% of the covered assets have not been sold or otherwise disposed of by the end of the eighth year, the guaranteed yield rate for year 9 will be reduced to TCF + 100 basis points.

If 80% of the covered assets have not been sold or otherwise disposed of by the end of the ninth year, the guaranteed yield rate for year 10 will be reduced to TCF + 90 basis points.

[e] The term of yield maintenance per asset category is as follows:
Mortgage-Backed Security Portfolio - none
Investment of the Acquired Association in United MBS Corp.,
  Investment of the Acquired Association in Equity Subsidiary - 1 year
Non-performing completed 1-4 family residential mortgage loan or property serving that loan that has been acquired by foreclosure. - 5 years
Anything not in the other categories, plus 5+ unit mortgage loan or property securing a loan acquired through foreclosures. - 7 years
Undeveloped land and investment in land subsidiary. - 10 years

[f] The yield subsidy is buried in the negative net worth note.

[g] Each of three distinct thrifts in this transaction has its own yield guarantee from FSLIC. The guaranteed yield shown is for covered assets owned by Columbia/Mile High, including those covered assets that Columbia /Mile High acquired from Pathway and Cardinal. For covered assets owned by Pathway and Cardinal the yield maintenance will be COF+250 for a term of 15 months only.

[h] The yield subsidy is buried in the note between New West and American.

SOURCE: Compiled by GAO from information obtained from FHLBB.

The CHAIRMAN. Senator Gramm of Texas.

Senator GRAMM. Thank you, Mr. Chairman.

Mr. Chairman, I am not going to get into an argument today with the General Accounting Office. I guess my feeling is, however, that it's awfully easy to come in when the war is over, and the bodies are strewn here and there, and second guess the generals. I don't know how we get people to come into these rotten situations and try to deal with them if everybody knows that after the shooting stops everybody else is going to come in and tell the world how they would have done it better.

I go back to the Theodore Roosevelt adage that it's not the critic who counts, not the one who points out how the strong man stumbled or how the doer of good deeds might have done better.

I think the reality of the situation is that Danny Wall has never had the resources that would have given him the broad options involved with closing institutions. As a result, he has consistently had to deal from a position of weakness. Second, he had a severe problem in terms of preserving confidence in the industry, since there was no money in the FSLIC while there was a trillion dollars of outstanding insured deposits. He was, therefore, under the necessity of trying to run a competitive process with the inability to have full public disclosure.

We are in short order going to adopt a bill that will give $50 billion to the FDIC. I believe that will give them greater options than the Federal Home Loan Bank Board ever had. I suspect, after all is said and done, that they are going to put together deals that in the basic approach are not too different from what the Federal Home Loan Bank Board has done. I think they are going to be more open about it. They are going to be able to be more competitive, which I rejoice in. They are going to be able to do it because they've got the money. They are going to be able to say no to marginal deals because, again, they have got $50 billion that the Federal Home Loan Bank Board did not have.

Having said that, my question has to do with the one part of these agreements that really troubled me more than anything else, because they represent an ongoing process. That is the so-called management agreements, whereby we are paying people to manage real estate and their payment is not based on the timely disposal of the property.

Have you all looked at these contracts? And I'd like to get some reading from you as to our capacity to go back and renegotiate these contracts.

Let me tell you why I think they're important. First of all, it makes me nervous to have the Federal Government directly or indirectly managing great quantities of property. I'm torn here by a dilemma. I don't want us to rush out and sell all of these assets on a firesale basis. On the other hand, I don't want us to sit on them for 15 years either. I want us to sell them when we can get rid of them without depressing the market and I want people to have an incentive to go out and sell them.

As I look at these management agreements that were part of many of the Southwest plan deals, they trouble me in terms of the lack of incentive and I'd like to get your response to that.

MANAGEMENT AGREEMENTS

Mr. **Bowsher**. We share your concern, Senator, because the incentive is more to sit on the assets and I think experience has shown over the years that when that happens they have a great tendency to deteriorate.

Also, as Bill Seidman pointed out down in San Antonio the other day, you have an overhang on the whole market down there that sometimes can be very bad for the economic recovery of an area. At the same time you've got the other side of the coin, which you mentioned, and that is you don't want to throw them all on the market at one time.

We have looked at these incentives. We have not looked at the particular issue that you have raised and that is the contract on some of these things and maybe we should do more work on that.

Senator **Gramm**. Well, if you would do that, Mr. Bowsher, and give us an outline of all the deals that have been made, to what extent are we locked in by a contract to these management agreements, to what degree do we have without getting the Federal Government sued to go back and change the deal? To the maximum extent possible, I want to give people incentives to dispose of these assets in an orderly way, because a firesale creates its own problems, but on the other hand, having all this property hanging over the market creates another set of problems.

Mr. **Bowsher**. That's right.

Senator **Gramm**. First of all, I'd appreciate it if you would give us a summary of what kind of deals we're in as far as property management is concerned, any suggestions you have as to the procedure we ought to follow in providing incentives and restructuring them, to what degree can we get out of these agreements, and anything else that you have in that area I would be very much interested in.

Mr. **Bowsher**. All right.

Mr. **Fogel**. Senator Gramm, to FSLIC's credit, one of the provisions they did put in the contracts was the fact that the Government had the right to exercise an option to purchase some of the guaranteed assets back, so as part of this we will get into that. That may be one way to get out of some of these deals where the new thrifts don't have a lot of incentives because of the tax benefits and everything else to sell them. So there may be a way as we look at these that we can take into account what FSLIC negotiated.

Senator **Gramm**. Well, any recommendations you have, I would appreciate it. In my view, the Southwest plan deals are done. We've got to look forward and get on with the big task, but this is one of the carryovers from the deals that bothers me, and to the maximum extent we can I'd like to try to get out of these asset arrangements and try to get some incentives back into the system.

Thank you, Mr. Chairman.

The **Chairman**. If I may say, I think those are very important points. We have that problem not just in Texas, where we've got the largest part of the problem but in other States as well.

I'm wondering, Mr. Bowsher, if you could give us—say within the next 2 weeks give us any thoughts you have on a sensible property disposition. I'm not asking you to invent an entire system, but if you've got some suggestions to make in response to Senator Gramm, I'd like to get them within that timeframe.

Mr. **Bowsher**. We will try to do it, Senator. It's a little tight, but we will try to do it, because I know of the markup and your plans. So we'll try.

The **Chairman**. Exactly. I appreciate that.

Mr. Wolf, let me ask you, in your testimony before the House Banking Committee, you referred there to an alternative approach to funding the savings and loan package. It sounded to me as if you had some very thoughtful and constructive ideas there.

What would be the specific components of an alternative financing plan as you would see it?

ALTERNATIVE APPROACH

Mr. **Wolf**. Well, I'm not sure I would say it's an alternative financing, but it gets back to the point that Senator Garn made earlier about whether there were resources.

To the extent that FSLIC had the ability to use notes, those could be used to transfer the deposits of insolvent institutions to other organizations and then provide us with a longer period of time to think through the assets that we will acquire out of those institutions. You don't need to do that with all of them. In fact, there's a fairly large amount of the money that's involved in maybe a third of the institutions. The other two-thirds of the institutions, while insolvent, are not major problems.

But the use of notes, not just in the past but more importantly as we go forward in transferring some of these deposits, permits us to do some of this maybe more expeditiously. It also doesn't necessarily require all of that borrowing from the REFCORP organization, and in fact shows up on the budget in the fiscal year that we issue the notes.

That's essentially the alternative approach that people can take to dealing with these institutions. You're not going to get rid of all of them that way and you've got to make a decision up front which are liquidation versus which are not.

The **Chairman**. Is there a dollar saving to be gained by toning that way?

Mr. **Wolf**. Well, if you do the notes you permit yourself to deal with the institutions quicker. It's very difficult to identify whether there is a dollar savings. It's a borrowing in the same sense that if you used Treasury borrowings or the REFCORP notes, but I think you give yourself alternatives to do some things faster and to do more liquidations versus mergers and our sense has been that liquidation in many of these would have been less expensive than doing a merger. Some of those mergers are very expensive, but quantifying it, I don't think anybody can do that at this point.

The **Chairman**. If we were to do that, in addition to using the notes, is it also possible to appropriate cash for expenditures in 1989; and therefore, we could score that cost for budget purposes for the notes and the cash in 1989?

Mr. **Wolf**. If you use notes or cash in 1989, they do count on the budget in 1989. That's not an off budget mechanism. That's just a fact.

Mr. Bowsher. And what it does do, of course, you've already done the look-see at Gramm-Rudman in 1989, so it would score in 1989 and then wouldn't be part of the 1990 Gramm-Rudman target problem you've got.

The Chairman. That's really a key issue and gets into the arcane nature of the budget process and Gramm-Rudman. I really want my colleagues and others to think about this because if we were to go that route and to find a way to raise the cash resources we need to do an orderly disposition, there is a way to do this within a time period that's ahead of us that actually would impact the fiscal 1989 budget for Gramm-Rudman-Hollings. In a sense we've passed those. We've got to pay the cost either way, so it is now simply a question of what becomes a preferred accounting treatment. We may, in fact, be able to go to a different accounting treatment and save ourselves some money in the process by giving ourselves a chance to be able to——

Mr. Wolf. Let me correct something you said. I don't think this is any different accounting.

The Chairman. No, I beg your pardon. Let me change that. I don't say it's different accounting, but it puts it into a different accounting period.

Mr. Wolf. Because you spend the money now instead of spending it later.

The Chairman. Exactly. But the point is, I think there are certain virtues to that in terms of the orderly disposition of the problem. I think that probably costs us less because we're not extending ourselves out into the future and paying interest costs that otherwise could be perhaps reduced. Also, we're not putting ourselves in a very awkward situation with respect to the Gramm-Rudman targets for fiscal 1990. That's really where the focus is now as we're crafting the new budget. It's always been my observation that the way capital markets look at the need to resolve a major financial problem that's already occurred is that the more cleanly it's dealt with, the more directly you hit it head-on, you pay for it, you keep the costs at a minimum, the markets already know the problem is there in a sense. They've discounted for that. So what you want is the most orderly cleanup and disposition of the problem as you can have.

It seems to me that there's a great virtue here because of the complexities of Gramm-Rudman and the perversities of Gramm-Rudman I might say, that we may well be better off to handle part of this in a fashion that lets us do an orderly disposition and charge part of that cost against the fiscal 1989 numbers rather than the fiscal 1990 numbers.

Do you essentially follow the logic of what I'm saying?

Mr. Wolf. And in fact some of the actions that the administration has taken may make it somewhat easier to do that because they have already taken control of many of these institutions. They ought to be in a position to make that kind of evaluation as to which, at least of the big dollar transactions, are more likely to be or should be a liquidation versus a merger and proceed with that.

So in a sense, the stage has been set to do that if that's the decision that people want to use.

The **Chairman**. Well, I think it's something we ought to consider. Let me yield now to Senator Garn.

Senator **Garn**. Mr. Bowsher, we have discussed at quite great length the preferability of cash and liquidation and using other resources rather than tax benefits in structuring future deals. Congress extended tax benefits, however, to banks last year and Bill Seidman recently endorsed the continued use of tax benefits on an ongoing basis. As a matter of fact, the FDIC last year, in the case of one big deal, made use of over a billion dollars of tax benefits in one deal—one transaction last year.

My question is, it isn't within the jurisdiction of this committee, but should Congress repeal those tax benefits?

USE OF TAX BENEFITS

Mr. **Bowsher**. I think the administration now has come out and said that they will not request that that legislation be extended and I know Bill Seidman did use it once, but it wasn't his preferred way and he would prefer not to use tax expenditures. I talked to him more fully again when I was with him last week on the subject because I was getting confused by what he was saying and what Darman was saying. But he very much now is with the administration position that they would just as soon see the legislation expire and they will not rely upon tax benefits as part of the workout in the future. That's going to be the administration position and that's the one that we recommend.

Senator **Garn**. So Bill has changed his mind after consultation with the administration. Is that what you're telling me?

Mr. **Bowsher**. That could be, yes.

Senator **Garn**. Well, I'm sure that your comment about him preferring to use other ways—I think FSLIC would have preferred other methods as well.

Mr. **Bowsher**. Yes.

Senator **Garn**. I think what's good for the goose is good for the gander and that was a very large deal. You know which one I'm talking about.

Mr. **Bowsher**. Yes.

Senator **Garn**. FSLIC has been criticized greatly from a large number of sources on using FADA to dispose of foreclosed assets. It's too costly, a waste of time, and so forth. At the same time, you criticize FSLIC for essentially paying private institutions to manage assets under the Southwest plan because it involves extensive monitoring costs.

My point is that either FSLIC or FDIC would incur substantial costs regardless of whether it manages property itself or whether it leaves it in the institutions for them to do so.

How should the insurer approach this problem or which way should the insurer approach this problem in the future? You've got costs either way.

Mr. **Bowsher**. You do have costs either way, there's no question about it.

Mr. **Fogel**. There are alternatives that both FSLIC and FDIC have that either one could use. One is, for example, the FSLIC can use its own employees. It can use receivership staff to liquidate, or it can contract with private sector contractors to liquidate.

The FDIC has a much larger staff that has been involved in asset disposition over the years and that's one of the reasons we favored having the FSLIC and FDIC staff get together. So we are not opposed to the general approaches that are now available. What we didn't see when we looked at the FADA organization was that there was a compelling need to have that, in addition to the three alternatives that were already available to FSLIC where they could already contract out to private sector, use receivership staff. So we would say that any of the three alternatives that are now available should be used in trying to dispose of the assets in the future.

Senator GARN. I know it's going to be very difficult for you, as the chairman asked you to come up with some recommendations, to do it in a very brief period of time because it is a critical question. It's been said by many people that the worst thing you can do is sell everything and the worst thing you can do is not sell everything. So it's a difficult problem. We would appreciate any suggestions because the markets in some of these areas are already so depressed and, unfortunately, some of the most depressed areas are where the biggest inventories are.

So if you do have any wisdom on that problem, I'm sure the entire committee would appreciate it.

Mr. BOWSHER. Well, we will certainly try. We've done some work here in the past and I think we'll be able to be of some help here.

The CHAIRMAN. Senator Bryan.

Senator BRYAN. Mr. Bowsher, the legislation that we have before us contemplates that there are going to be some future insolvencies and you have outlined kind of a litany of horrors really in terms of some things from your perspective that were done by way of the acquisition process that ought not to have been done. You don't elevate them to the level of criminal misconduct, but you do suggest that things in your opinion could have been done differently.

My question now is, putting aside the past for the moment, one suggestion you have made this morning is that you think that the legislation we're acting upon ought not only to make the option of tax benefits a part of the consideration but ought to mandate that. Am I correct in that recommendation, Mr. Bowsher? In terms of considering the costs of these acquisitions?

Mr. BOWSHER. Yes. If there are any tax benefits involved, we think they should be part of the calculation. In fact, I'm sure that's what's included in the administration's proposal.

Senator BRYAN. Now what other provisions would you suggest that we ought to include in this legislation which is not a part of the legislation now?

SUGGESTIONS FOR ADDITIONAL PROVISIONS FOR LEGISLATION

Mr. BOWSHER. One thing that worries us a great deal that was put into the legislation is taking away what I call the independence of the FDIC. In other words, the Chairman will no longer have a fixed term, and so I think that ought to be looked at very carefully to make sure that you want to go that route.

I think the term of office gives the individual a certain independence which you need in these kind of situations here. They are making very tough decisions as to whether to close or merge or things like that. A lot of pressure can be brought on people in those kind of positions and I think the independence that's been there before ought to remain there.

The other thing is staff resources. One of the problems we have gotten into over the years is when a problem was recognized to a certain extent, and people went for additional resources, but we ran into budgetary problems with the Gramm-Rudman target problems, and resources were not provided.

I think you've got to recognize what a big, big job this is to manage, this tremendous program. In other words, you're going to have really three insurance funds here now. You're going to have the FDIC for the banks. You're going to have the new thrift insurance fund for the healthy thrifts. And then you're going to have the corporation where you're doing the workout on the insolvent thrifts. And you're going to have to have competent people and you're going to have to have enough of them to do this job right.

I know one of the things Mr. Seidman is arguing for is some independence on the budgetary aspect which we feel is important because if you don't have the resources you're not going to be able to do these jobs well and we will be back again, as Senator Garn said, being the critics because something has gone wrong. So I would very much argue for resources.

Then the one last thing would be the independence of the bank examiners. In other words, the examiners that are going in to examine the individual banks we feel should be part of the insurance fund rather than the board. They are the ones that have to know what's happening out there and if something is happening that shouldn't be happening they should be able to take action quickly rather than to let problems escalate and become a big hit on the insurance fund.

Senator BRYAN. So you would recommend that the examiners themselves would be divested from the board and become part of the fund in terms of the FDIC's responsibility?

Mr. BOWSHER. Yes.

Senator BRYAN. When you talked about the independence, your first point in your series of recommendations, are you making reference to FDIC or are you making reference to the Federal Home Loan Bank?

Mr. BOWSHER. The FDIC.

Senator BRYAN. What's your comment with respect to the incorporation of the Federal Home Loan Bank into Treasury?

Mr. BOWSHER. Well, I think it could be either done there or it could be an independent group. We don't have any strong feeling about that.

Senator BRYAN. Are there any powers that we need to give the board in terms of reopening some of these transactions that occurred before the end of the year to maximize the savings to the taxpayers, any additional powers that need to be incorporated into this legislation?

Mr. FOGEL. Based on our analysis of the bill so far, we think there are sufficient powers in there to allow them to do that, but I think as we said at the beginning we'd like to see the Resolution Trust Corporation be required to look at the deals. But in doing that you'd have to look at the provisions of the contracts in each deal to see what you can do. We do not favor abrogating the contracts as such.

Senator BRYAN. Indeed, I believe your testimony is that your counsel indicates you can't do that.

Mr. FOGEL. That's correct.

Senator BRYAN. Should we incorporate any additional provisions by way of statute in terms of the kinds of things that the board must consider in terms of evaluating the cost benefits to the taxpayer?

Mr. BOWSHER. I think just that one main one and that is if there are any tax benefits they should be counted.

Senator BRYAN. How about the procedure, the blind bidding procedure?

Mr. BOWSHER. Well, I would certainly hope that the bidding process would get straightened out and I would think that with the experience that the FDIC people have that they can straighten out the bidding process. You might want to put some language in there that says this is the sense of what you want, a fair bidding process, giving everybody an equal opportunity to go through the qualified bidders and I'm sure that lawyers at the FDIC can draft something that would be very fair.

Mr. FOGEL. But I don't think we favor constraining the new FDIC or whomever is going to do this real narrowly in terms of how they have to negotiate mergers or liquidations. Sometimes they need some flexibility. So perhaps a sense of making sure it's fair and equitable is what you need. But I don't think we favor real specific direction to them as to how it should be done.

Senator BRYAN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Bryan.

Senator Graham.

Senator GRAHAM. I'd like to follow up if I could on the questions that Senator Bryan was asking relative to the independence issue.

There was a recent study by the Mid-America Institute Task Force which reported that neither the Home Loan Bank Board nor FSLIC currently employ bank examiners. Rather, that is done by the 12 district banks. Is that a correct statement?

Mr. BOWSHER. That is a correct statement.

Senator GRAHAM. The report raises some concern about whether there are adequate safeguards within the 12 district boards which are owned substantially by the member institutions in order to avoid conflicts of interest arising.

What do you believe about the current system?

Mr. BOWSHER. That's the point that I made there with Senator Bryan. That is, we think that those examiners should report to the insurance funds and not be out there as employees of those Bank Boards.

Mr. FOGEL. And the way the bill was drafted by the administration when it was submitted to you does not make clear exactly how that process works. So we think it ought to be clarified and made clear that the examiners work for the insurance fund, not the district banks or the bank board.

Senator **Graham**. You mentioned another area of concern was the proposal to make the Chairman of FDIC serve essentially at the pleasure of rather than have a fixed term. Another organizational provision would essentially grandfather in the current membership of the Home Loan Bank Board.

Do you have any comments on that proposal?

Mr. **Bowsher**. Well, I think that's the key issue of whether you want Mr. Wall to continue as the head and under that procedure he would, if I understand it right. And the other possibility would be to just go through a regular nomination and confirmation.

Senator **Graham**. I don't want to personalize this, but from your view of the operations of Mr. Seidman as head of FDIC and Mr. Wall as head of FSLIC, on what basis would you support a proposition that would make Mr. Seidman at risk and give Mr. Wall job security?

Mr. **Bowsher**. That's a loaded question, Senator. That's my concern. In other words, Mr. Seidman or whoever holds that job needs security. One thing I might point out very carefully here is the change they are putting through is not to take away his Board membership, but what the President could do is ask for somebody else to be Chairman. We have that in some other regulatory bodies and what happens generally in that case is that the person leaves anyhow, even though they've got 1 or 2 or 3 more years to go in their term. If you look at the SEC Chairman you'll notice that generally when the chairmanship is taken away, then the person leaves. In addition to the issue of independence, I think you get too much turnover. One of the things you need in these kind of positions is consistency of tenure of office. So we strongly recommend that the FDIC Chairman continue to have a term of office.

Senator **Graham**. You don't want to proceed further with the loaded question?

Mr. **Bowsher**. Well, I think it's a question that the administration and the Congress are going to have to deal with.

Senator **Graham**. On the question of asset disposition, there seems to me to be an issue that we are likely to be asked to legislate on and that is, should the responsible parties who are holding the assets either for a regulatory agency, for an insurance fund or for an assisted institution, be asked to operate in a manner that they consider to be in the best interest of their immediate employer or should they be asked to operate in a way that might be in the best interest of the larger community in which that major employer is located? Do you see the likelihood of a division between those two groups; that is, where the interest of an individual institution's disposition of assets might be antithetical to the interest of the community in which that institution is located?

ASSET DISPOSITION

Mr. **Bowsher**. Well, I think you have to take into consideration the local community and the local markets because that's the market you're selling into. I agree with Senator Gramm that to do it as expeditiously as possible and at the same time you really have to have experienced people making some judgment as to if you do this does it completely dampen or drive down the overall market.

So I don't think you can separate the two. I think those two have to be considered by the people doing the job.

Mr. FOGEL. What you want to do, too, is try to build in some incentives for the people who hold the assets to sell them as quickly as they can at the most favorable costs. One of the problems with the way some of these deals were done in the Southwest is that it's to the acquirer's benefit from a tax perspective to sell the asset at the lowest percentage of book value thus generating the largest loss because he gets to keep the tax benefits. That's the reverse of the type of incentive that you want.

Mr. BOWSHER. Mr. Chairman, there's one more issue that we should respond to Mr. Bryan on, that's a cap on notes. I'd like Fred to explain that.

Mr. WOLF. The point is relatively simple. The administration's bill includes a cap on the amount of notes and other related borrowings by either FDIC or the new S&L fund. That cap has been set at an amount which is basically almost what the FDIC has out right now. There's some degree of concern that that's too restrictive and somebody ought to look at it and probably raise it up to a number that's closer to what their net worth is, rather than an arbitrary half of net worth.

The way it works out, it has an impact on how independent they can be in carrying out their decisions and actions. If that cap is so close that every time they need additional money they have to go to Treasury, that's probably not a good idea. But an overall cap at some point we have supported as well. We just think this one is too tight.

The CHAIRMAN. I want to come back, Mr. Wolf, to the possible option that we were discussing earlier of looking at the financing side of the package and the degree to which we might save money and gain other advantages if we were to raise more of the bond money this fiscal year, 1989, and treat those problems that we can in what is left of the fiscal 1989 year.

For example, it seems to me that one of the things we could do if we did it that way—now let's leave open the amount of money that we would draw down—is to use it to go in and deal with some of the December deals. We could go in and we could buy our way out of some of those arrangements that are very expensive and which carry with them price tags that extend out at least 10 years into the future.

So, one of the things we could do is follow the advice that you in part have given us here. And that is to go in and work our way out of some of those deals where we properly can, at a less expensive cost because we deal with it now. We sort of fronted the resolution of that problem. So that would be one place where we could use a large infusion of cash presently and save ourselves money and avoid this problem of sort of future complications with Gramm-Rudman-Hollings from 1990 on.

It seems that, second, there are a number of institutions that have not yet been dealt with. The FDIC has been taking over more of these each day. They have taken over roughly 120. I gather there's a total of some 350 out there that are in that general category. It seems to me that for the ones that they have now taken over, we could use cash to resolve those situations and not lock ourselves into long-term financing arrangements with fixed fees.

There may also be some other S&L's that we don't see yet that would fall into this category prior to the end of fiscal year 1989. But if you take those two general combinations, what would be the advantages of taking and trying to treat whatever we can appropriately treat in the remainder of fiscal 1989 very directly? I'd like you to respond to that, Mr. Wolf.

NECESSITY FOR QUICK ACTION

Mr. **Wolf**. I think you've kind of gone through the reasons why you want to move. We have said in the report that Mr. Fogel prepared for the House Banking Committee that one of the key things is to as quickly as possible deal with the insolvent institutions, get them out of the market and then deal with the assets. That's in effect what this kind of thing—whether you're using notes or additional cash— that's what that permits. Whether it helps you to buy out the existing deals or not, I'm not sure that we can say, other than it's worth pursuing to the extent we can, but you would have to look at each one of those agreements. I think where the place to start would be with the 350 or whatever the number of insolvent institutions is, because I think you get more payoff more quickly by dealing with that than right way trying to deal with the deals that are done. But I don't know that we can answer that second part as clearly, but certainly the main thing you get out of it is that you get up front a quicker ability to deal with the insolvent institutions and stop losses and you're not forced to make mergers then, which are expensive.

The **Chairman**. Well, it seems to me that that's part of what starts to emerge from the analysis you have done. This is a very complex activity to say the least, but it looks as if by not going the assisted merger route that we may be able to go in directly liquidate some of these situations, do it quickly in an orderly fashion, and keep our costs down because we will have acted quickly. I'm even wondering if the financial markets might not even like the orderliness of that in such a way that maybe our financing premiums would come down somewhat.

Mr. **Bowsher**. You mentioned earlier about keeping it cleaner and keeping the whole process where people can understand it gives confidence and I think one of the problems here has been the complexity of these deals. It's going to be a problem that we live with for a long time.

The other thing I think is very important, Mr. Chairman, and that is we have 350 insolvent S&L's to deal with here now in the next year or two that weren't part of these deals and so being more direct with them, being much more upfront as to what we can do and get the assets known as to what's really worthwhile and what isn't, that's the way to go. There's just no doubt about it.

The **Chairman**. One of the things that we would save ourselves is that this estimate of the cost of keeping insolvent thrifts open—we've used this figure of $30 million a day or $35 million a day. The figures vary. That's a lot of money. It seems to me one of the things we could reduce, the faster we can go in and shut down an insolvent thrift and undertake the liquidation, then, is the run on and the mounting of those losses in those individual institutions?

Mr. BOWSHER. That's right.

The CHAIRMAN. Wouldn't we gain that?

Mr. BOWSHER. Yes.

The CHAIRMAN. Mr. Fogel, did you want to add a point?

Mr. FOGEL. Well, I was just going to say, the other thing that you really do if you address this now is you don't put the Government in a position of having to continually put up more money, which we're going to have to do—there's no doubt in our minds—with these 1988 deals, once we find out the true value of these institutions; it's an openended commitment that we've got. It's going to end up I would estimate on a cash basis costing more than $60 billion. So anything we can do with these 350 to resolve them quickly has got to save the Government in the long term, but you've got to have the cash this year.

The CHAIRMAN. If I can just pursue this with the patience of my colleagues, I think a lot of the structured decision making was to work around the Gramm-Rudman-Hollings constraints.

Mr. BOWSHER. There's no doubt about it.

The CHAIRMAN. So that problem, when Paul Volcker was here he coined the phrase that was with sort of a slight grin, he commented on the complexity of the financial engineering of the cost side of the package as an effort to try to move around this Gramm-Rudman-Hollings regime, but it seems to me that this may be a way to do that in a sense, to the extent that that was a goal that drove the construction of the financing side of the plan—this may be another way to work with the constraints of Gramm-Rudman-Hollings and at the same time reduce the cost at least in part to the taxpayers here of what has to be done. Is that a fair summary, Mr. Bowsher?

Mr. BOWSHER. That's a very fair summary and the only caution I would have is be sure you get the reforms.

The CHAIRMAN. Absolutely. We've said from the beginning we are not going to provide a dime until we've got the reforms in place because that just wouldn't make any sense.

Mr. BOWSHER. And I've got one more reform to suggest, but you were going to come back to the Perelman case. I don't know whether you are or not.

The CHAIRMAN. I intend to.

Mr. BOWSHER. All right. I'll save my reform until then.

The CHAIRMAN. Let me make a note so neither one of us forgets to do that.

But I'm wondering if you could—is there any way to size up how many tens of billions of dollars of bonds would have to be sold now to create the cash within the remainder of fiscal 1989 to go out and do as much of the cleanup as we can right now?

Mr. WOLF. We can make a couple of assumptions and come up with some numbers that would be a combination of cash plus notes that could be used.

The CHAIRMAN. OK. I think that's very important that we look at that and I'd also want to have a judgment as to whether the amount coming now would phase the capital markets in any way as an add-on financing requirement. I'm inclined to think not, with just the sheer volume of financing that goes on each day in total. If we're talking about increments of say $10 billion in the overall context of the financial markets, I would think they could handle that without any great disruption. But I'd like your qualitative view on that as well.

Mr. WOLF. To the extent you use notes, it obviously has less of an impact on the market because it's not taking cash out immediately.

The CHAIRMAN. Very good. I'd really like you to apply your creative thinking as to how we might see how that alternative financing mechanism might look, and the advantages and disadvantages that are associated with it. I think we may find ourselves a way to save a lot of money, and if we can, I would hope that a lot of people would like the thought of being part of doing that.

Let me now yield to Senator Bryan.

Senator BRYAN. Thank you, Mr. Chairman.

I just have one question and I'm going to yield my time back because I'm intrigued by the Perelman case and how that evolved. That ought to be the finale to the testimony this morning.

DEALS MAY HAVE PUT SOLVENT THRIFTS AT A DISADVANTAGE

In your testimony you indicate that the way the deals were structured placed—I believe your words were—put the solvent thrifts in a competitive disadvantage. My question to you is, are you suggesting to us that that may have destabilized some solvent thrifts and we may, as a consequence of the way some of those deals were structured, may have rendered them less able to withstand the economic viscidities of the marketplace and thereby in fact added numbers to some of these problems?

Mr. BOWSHER. I think that's a possibility. What we're really saying is that in the future you've really established now a whole new system literally of S&L's that have guarantees from the Federal Government up to 10 years. That gives them a cost advantage over the other institution down the street you might say. So there's no question that that could have an impact in the next 10 years. I think it's been too soon yet to see that impact but I think you've given great advantage to the S&L's that are in part of the 1988 deals.

Senator BRYAN. I don't want to put words in your mouth, but by the use of the term "impact" are you suggesting that it might have some additional failures in the market?

Mr. BOWSHER. I think that could be a possibility but I wouldn't want to jump in with any judgment there.

Senator BRYAN. I am eagerly anticipating the Perelman story. I'll yield back, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Well, I am anticipating that also, but not so much so that I wouldn't like to ask a couple of questions.

In the liquidation circumstance, is it the policy of FSLIC to transfer liabilities, i.e., the deposits, to a solvent institution? Let's say if you have an institution with $100 million of insured deposits and were closing it down, liquidating it, technically what happens to the $100 million in deposits?

TRANSFER OF DEPOSITS TO THE NEW THRIFT

Mr. **Bowsher**. You move it into the new thrift.

Senator **Graham**. Are there ever instances where it's moved——

Mr. **Bowsher**. It's generally an existing thrift.

Senator **Graham**. An existing thrift which has taken over those deposits?

Mr. **Bowsher**. Yes.

Senator **Graham**. Is it generally practiced that the acquiring institution that takes over the liquidated institution and its deposit base pays some fee for those deposits?

Mr. **Bowsher**. That's all part of the negotiation.

Senator **Graham**. So the general set of institutions who are potential acquirers are made aware, among other things, of what the charge will be in order to get access to that deposit base?

Mr. **Bowsher**. Generally what they say is, wouldn't you like to have these additional 5,000 customers or deposits or something like that and how much are you willing to pay for this? And here's what we think it's worth, and things like that. Those are the kinds of negotiations that take place on that part of it I believe.

Senator **Graham**. On that aspect, have you been satisfied with the amount of value that's been placed on those deposits?

Mr. **Bowsher**. That's pretty hard to tell. I don't think we have a good opinion on that, Senator. We have been looking at the overall deals and I just don't think we have a good judgment on that.

Senator **Graham**. A second question relates to the understanding relative to the future interest rate policy of assisted institutions. We had testimony recently from Mr. Roger Martin that one of the institutions in my State had a gentlemen's agreement that it would not engage in above market interest rates in order to augment its deposit base. It in fact has done so. Are there any of the transactions that you have reviewed which have either formal or informal understandings relative to what the interest rate policy will be of a surviving institution?

Mr. **Fogel**. No, we did not see those. One of the objectives of the mergers is to try to reduce the Texas cost of funds so that the interest rates that all the institutions are paying is less than it would have been had they not been merged.

And we heard some testimonial evidence down in Texas last week that it is dropping some, but we haven't looked into that in detail.

Senator **Graham**. If you look at a list of institutions in Texas or any other State that has been significantly affected by assisted mergers, do you see that the assisted merger firms are paying interest rates at the general market?

Mr. **Bowsher**. We have not made that comparison, no. Some I think are still paying above.

Mr. **Fogel**. But it is dropping some.

Mr. **Bowsher**. Yes.

Mr. **Fogel**. But we haven't looked in detail. The data needed aren't available yet.

Senator **Graham**. You say it is dropping. Is that the differential between what the assisteds are paying and what the market is, is dropping?

Mr. **Bowsher**. Yes.

Mr. **Fogel**. Yes.

The **Chairman**. Thank you, Senator Graham.

In looking at the deals that were done in September, one that looked odd to me was the Perelman transaction because you had somebody coming in with no previous history or interest in the savings and loan business and in a relatively short period of time, there is a lot of assistance as part of that package as nearly as I can understand it.

Can you tell me in looking at that particular situation what your observations are?

PERELMAN CASE

Earlier you said you had a particular point that you wanted to raise, and this might be a context in which to raise it.

Mr. **Bowsher**. Well, I think in the writeup that appeared in the paper what you see is a pretty good summary of probably what happened in that case. I asked my people does that story look like——

The **Chairman**. And I guess if we are going to use the story as a reference point we had better identify what we are talking about and put the story in the record so that we....

Mr. **Bowsher**. All right. That is the Washington Post article that appeared in Sunday's paper, I believe.

[The following newspaper article was subsequently submitted for the record:]

From the Washington Post, 3-12-89
p. A-1; p. A-18

A Look at One Investor's S&L Bargain

Documents Show That Perelman Paid Less, U.S. More Than Reported at the Time

By Kathleen Day
Washington Post Staff Writer

When federal regulators sold a bankrupt Texas savings and loan to investor Ronald Perelman in December, they said that he would put $315 million into the thrift and that the federal government would provide $5.1 billion in assistance.

But documents describing the transaction show that regulators from the Federal Home Loan Bank Board painted a picture that was far too rosy.

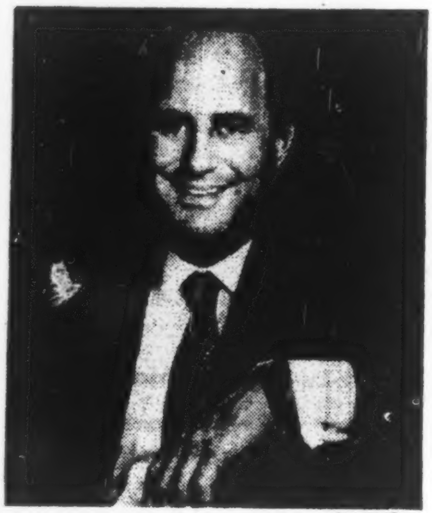
Perelman, using funds from his Revlon cosmetics empire, actually put up $160 million to buy 75 percent of First Gibraltar Bank, an S&L created from five bankrupt Texas thrifts. (A First Gibraltar executive owns 5 percent, the government 20 percent.)

First Gibraltar itself borrowed the remaining $155 million in new capital from the investment firm of Shearson Lehman Hutton, making the transaction a leveraged buyout.

And, when tax breaks are included, the government has promised to give First Gibraltar not $5 billion, but $6 billion in federal aid. Adding interest costs over 10 years boosts the total government outlay to $10.4 billion, according to the documents.

The bank board has kept secret the details of the Gibraltar sale—and of the deals it arranged last year to dispose of another 178 insolvent S&Ls—by contending that their release would undermine negotiations with investors. It disclosed the terms of the transactions to Congress only after contracts were signed and lawmakers protested they were being left in the dark.

The agency still refuses to make documents describing the deals public, but copies of bank board papers spelling out the costs of the Perelman agreement were made available to The Washington Post.



Associated Press

Ronald Perelman: His deal is typical of others.

Documents Detail Investor's S&L Bargain

PERELMAN, From H1

The $10.4 billion that Perelman won breaks down into $8.9 billion in cash payments and $1.5 billion in tax breaks over the 10 years. Perelman can use the breaks to lower taxes by $1.5 billion at MacAndrews & Forbes Holdings Inc., his investment vehicle, which counts Revlon Group Inc. and First Gibraltar among its subsidiaries. First Gibraltar also will pay several million dollars in fees that Perelman owes to the lawyers, accountants and investment bankers who put the sale together.

The financial prizes he won are typical of the giveaways that regulators used to entice Wall Street gamblers to buy ailing S&Ls before Dec. 31, when many tax breaks expired, according to congressional investigators and investment bankers familiar with the deals.

For example, S&L regulators said New York financier Lewis Ranieri put up $200 million to buy United Savings Association of Houston in December. Actually, Ranieri put up $90 million and Shearson Lehman agreed to lend United Savings $110 million "sometime in the future," according to an official at an investment firm familiar with the deal.

Regulators long have allowed healthy and marginally healthy banks and S&Ls to count some borrowed money as capital—the cushion financial institutions use to absorb future loan losses. But many government officials, including some in the Bush administration, question the wisdom of allowing weak S&Ls that survive only because of government subsidies to borrow money to provide that cushion.

A spokesman for Perelman defended the use of borrowed money, and said that if Shearson can't sell the $155 million in bonds it holds in First Gibraltar within 90 days, Perelman is obligated to buy them. In that case, First Gibraltar will owe Perelman $155 million plus interest over the life of the bonds.

The General Accounting Office estimates that when the rush to close deals ended on New Year's Day, S&L regulators at the Federal Home Loan Bank Board had promised to pay at least $60 billion over the next decade to scores of wealthy investors who took the 179 troubled thrifts off the government's hands. The bank board arranged most of the deals last December, just before tax benefits expired.

The deals were instant moneymakers for the investors and for the investment firms that brought the buyers and sellers together. In Perelman's case, if the $1.5 billion in tax breaks are distributed evenly over 10 years, he would save enough this year to just about cover his $160 million investment.

Financiers who invest in S&Ls will use such tax breaks, federal aid and borrowed funds to earn an estimated return of 30 percent to 60 percent a year over the life of the deals, according to analysts familiar with several of the transactions. That is double to quadruple the return of 15 percent or less that is typical for investors in healthy banks and S&Ls.

Internal bank board documents show that the government would have saved about $4.1 billion by closing First Gibraltar and paying off depositors rather than selling the institution to Perelman.

A board analyst calculated it would cost $6.3 billion to liquidate First Gibraltar, board documents show. That compares with the $10.4 billion the institution will receive in payments and tax breaks under Perelman. Cost savings would have been similar in many of the other deals, according to other bank board documents and congressional investigators analyzing the sales.

"The deals amount to very, very expensive government financing," said David Beim of Dillon, Read & Co., a New York investment firm.

Regulators have given differing rationales to justify the decision [illegible] sell rather than close the institutions. The bank board's chairman, M. Danny Wall, has pointed out repeatedly that the bank board lacked the money to close the thrifts, leaving regulators no choice but to seek other solutions.

Bank board member Lawrence White has said that most of the deals completed at the end of 1988 would have been the cheapest solution even if the bank board had the cash to close the S&Ls.

A study commissioned by the bank board and released last week questioned whether sales were cheaper than closing S&Ls. The Mid America Institute for Public Policy Research said the regulators' methods of estimating costs of both courses "is subject to considerable error" so that "only imprecise comparisons" can be made.

Congressional auditors from the GAO say the government—and taxpayers—would have been better off waiting for Congress to supply the necessary funding to shut the 179 S&Ls, which the bank board said would have lost a total of $4 billion in 1989 if they were left open and not sold. "I think the deals are more expensive than the alternatives," said Frederick D. Wolf, the GAO's chief S&L and bank analyst.

The $8.9 billion that the government will pay Perelman will make up for the lost principal and interest on insured loans made by the previous management. Through 1999, for example, First Gibraltar will receive $4.8 billion in cash from the government to compensate it for losses on the face value of loans, and another $4.1 billion to cover lost interest payments on those loans, according to bank board documents.

The $8.9 billion in income will not be taxed. The S&L also reaps millions of dollars in tax advantages by claiming losses on the bad loans, even though the government has reimbursed it for the losses. The advantages flow directly up to Perelman's cosmetics empire, shaving his tax liability by $1.5 billion over the next decade.

Perelman first became involved in the First Gibraltar deal at the request of Gerald J. Ford, who controls 23 banks in Texas and New Mexico with $23 billion in assets, and Robert K. Utley, a Texas real estate developer. Ford and Utley were interested in buying First Gibraltar but lacked the money, and turned to Perelman.

Under their agreement with Perelman, Ford owns 5 percent of First Gibraltar and will be running it day [illegible] at a salary of $1 million a [illegible] Utley was to share with Ford both the 5 percent stake and management responsibilities, but previous problems he has had repaying real estate loans raised concerns among regulators.

The regulators also were troubled by the fact that Utley is president of Seamen's Corp., a Dallas S&L holding company, Utley said during a recent interview.

Bank board officials decided that there was not enough time to investigate Utley's background before the year-end deadline for closing the deal. So they demanded that Utley temporarily withdraw.

"I feel they were overly cautious, but it was reasonable," Utley said. Until the bank board completes a background check, he said, he will serve as a consultant to MacAndrews & Forbes on how to run First Gibraltar.

GAO officials and some S&L executives have expressed concern about Ford's salary and about Utley's previous business dealings. The GAO has cited excessive salaries and a predominance of S&L executives with strong ties to the commercial real estate industry as two key ingredients contributing to the industry's problems.

The bank board responds to the concerns by saying that there is a much stronger regulatory apparatus in place to make sure S&Ls are not abused by their owners or top officials.

Several members of Congress and in the administration also have said they are worried that the deals contain hidden costs that are hard to measure but may come back to haunt the government. The GAO says that selling ailing S&Ls to investors keeps institutions alive in regions that already are overbanked. Too many banks and S&Ls competing for too few good investments contributed to the S&L crisis, they say.

GAO officials also say the bank board has created a class of institutions such as First Gibraltar that compete unfairly because they have the benefit of government subsidies.

And they worry that in the long run many of the S&Ls that the government has spent billions of dollars trying to rescue will fail again.

The Perelman deal angered a rival bidder, Ford Motor Co. Bush administration officials say Ford offered $200 million in cash, or $40 million more than Perelman. The Blackstone Group, a New York investment firm that advised the bank board on the First Gibraltar transaction, decided that Perelman's offer was the best of the bids. Bank board officials said Ford demanded more federal aid than Perelman.

Mr. **Bowsher**. And what you see there was that the investor was finally the one that really became the owner and that the money that was put in there wasn't all his own. He reached out and borrowed a good portion of that money.

The one thing that worried me a great deal about it as I read it and as I became aware of it is the million dollar salary that the individual wanted down there. If you remember, as part of the Chrysler bailout situation and some of the other ones that we have done, we have always asked people either to take pay cuts or to freeze wages and things like that.

In other words, we didn't use taxpayers' money to set new records for management compensation, and so one of the questions I wondered whether Congress shouldn't consider is whether they want to put some guidance into the legislation on compensation.

You have to of course have a high enough salary to attract competent people, but that salary level of $1 million——

The **Chairman**. Well, that is only four times what we pay the President of the United States. So I suppose that was probably thought to be——

Mr. **Bowsher**. And even if you compared it to CEO's of other companies, why, it is really very, very high, and I think, if you remember Lee Iacocca and if you look at Lee Iacocca, who did a really superb job of getting Chrysler out, if you look at Stan Crane up at Conrail, if you look at the leadership out at Lockheed, if you look at the ones that were successful in these large bailouts, they were able to get big salaries after they were successful because the Government was out and it was up to them, to whatever the board of directors wanted to pay.

But to have that as part of the bailout here, that I really worry about.

The **Chairman**. Well, I am troubled about that, too, and I think that it is almost like a front-end fee when you take those high salaries in the beginning.

Mr. **Bowsher**. Yes.

The **Chairman**. There has been no workout yet. There will be presumably a workout over time, but one that I think provides incentives to the acquirer, but would not be too generous from the point of view of the taxpayers. I think there is a serious question as to whether there shouldn't be some restraint just required as part of these packages.

I am still very much disturbed about the fact that the plan that we have before us in effect. If we were to enact it exactly as is, the plan provides an unlimited flow of future money out of the Treasury. It provides no limits whatsoever.

We could find out that its cost is $100 billion, $200 billion. Who knows what the final figure will be? But unless we put some caps in there so that we have an opportunity to retrieve this problem, and if we find that it is way beyond what otherwise is estimated, we would find ourselves in a position where in effect we have put the taxpayers 'name literally on a blank check.

I am not aware that we have ever done that before.

Mr. **Bowsher**. We have never done that before. We never have. Even, you know, like New York City. A lot of people didn't realize that what we really had there was short-term financing. New York City had to repay that loan every year.

So we have always had bailout programs here that had caps or had—if you remember, even in the Chrysler deal they took it down so much at a time.

The CHAIRMAN. Right.

Mr. BOWSHER. And the Board had to review that each time.

So this is a much more openended arrangement.

I think one of the things that Congress ought to consider is, one, make sure you get all the information on these deals up front, which you said at the beginning of the hearing that you were going to request, and the second thing, I think, is when these initial audits are done and when we realize—finally find out what the cost of the notes are et cetera, then I think the corporation should report back to the Congress and tell them exactly what the program is going to cost because that is the first time we will really know.

I mean, right now we are still playing with what I think are very preliminary figures.

The CHAIRMAN. I think it is fair to say that putting a cap on doesn't injure the process in any way. All that does is to require that we revisit the issue if we are skating above what were thought to be the outer limits.

Mr. BOWSHER. That is right, yes.

Yes, and I think you can write the legislation so it gives you the oversight opportunity without also tying your hands in that.

I don't think most people realize how big this situation is.

One thing I asked my staff is go back and just tell me how much was the Marshall Plan, and that was $13 billion. If you escalate that to current year dollars, you get up to $60 some odd billion.

Now, if you look at it as a percent of our GNP, why, you would have to have a program that is going to cost $250 billion to take that much out of our economy today.

But you can see here that actually in escalated dollars this is bigger than the Marshall Plan. The Perelman deal is bigger than Chrysler, New York, Lockheed put together. So we are talking here about huge sums of money that the American taxpayer is going to have to come up with.

The CHAIRMAN. I think that is a very powerful illustration.

When it comes down to the competition that took place in what is referred to as the Perelman deal, how carefully were you able to reconstruct the bidding process in that case and who got invited out of the line, and who got to the front of the line? What can you tell us about that?

Mr. FOGEL. We have got some details on that, Senator. As you know, FSLIC asked Blackstone Financial Management to do an analysis on this to value and compare proposals and make a recommendation.

Initially, we were told——

The CHAIRMAN. Now, this is before they settled on a deal?

Mr. FOGEL. This is before they settled on the deal that they did, that is right.

And Blackstone presented an analysis of what it would do. Then, what we are aware of, is the Bank Board said that it got a number of bids and that this was narrowed down to, oh, around half a dozen finalists.

I think one of the things that concerns us some about this is there is some litigation now among some of the people that didn't get selected, but it did narrow it down to about half a dozen or around four, and then the Bank Board went ahead and did the negotiations, or FSLIC did, to decide who they were going to pick and, as Mr. Bowsher said, the group they started negotiating with didn't have enough capital. It is almost like it is not——

The CHAIRMAN. The one out of the four that was selected as the prime target didn't have enough capital?

Mr. FOGEL. Right, and that is when Perelman came in.

The CHAIRMAN. Was Perelman part of the initial list of four?

Mr. FOGEL. By that time, when it got down to the four, he was, yes.

The CHAIRMAN. So out of the four there was somebody else that they liked the looks of the best, and then as they got closer to doing that particular deal, the financial adequacy of that particular bidder was not adequate and that one dropped out, is that right?

Mr. FOGEL. Perelman was, by that time, in with the group that got it.

The CHAIRMAN. Say that again.

Mr. FOGEL. Perelman by that time was in with the group that did get the institution.

The CHAIRMAN. So he joined the group? Is that what happened?

Mr. FOGEL. Yes.

The CHAIRMAN. He came in at some——

Mr. FOGEL. Yes, he did.

The CHAIRMAN. Do you know when that happened? How late in the game did that take place?

Mr. FOGEL. We are not aware. Sometime by the fall, but we are not aware of the exact time.

The CHAIRMAN. It is still not clear in my mind. Was this the group that was found to be undercapitalized and then he joined that group or is this a separate group that he became part of?

Mr. FOGEL. He joined the group that was one of the primary bidders to assure that they had enough capital.

The CHAIRMAN. I see.

Mr. FOGEL. Yes.

The CHAIRMAN. So he became part of one of the other groups of four that were in the bidding?

Mr. FOGEL. That is right.

The CHAIRMAN. So he joined it.

Mr. BOWSHER. If you remember earlier in my testimony, Mr. Chairman, I described another one of the deals, where actually the group—a thrift—turned out to be insolvent, that thrift went into the package, literally; then the investor took it all. Here, again the heavy investor became really the majority stockholder by far.

Mr. FOGEL. And that was not too atypical. In other words, you had people bidding on these packages and one of the things FSLIC would say, well, how much capital do you want to put up, and what they would say was I want to put up X millions of dollars, and FSLIC would go behind it and find that they didn't quite have that much capital. So they would have to go out and seek other investors to assure FSLIC that they could raise the necessary capital.

The CHAIRMAN. So Mr. Perelman was somehow then grafted onto this group.

Mr. FOGEL. Yes.

The CHAIRMAN. And they went ahead and they went through and they were finally selected.

Do we have a sense as to that final selection process as to how the decision is made as to who the three are that lose and the one is that wins?

Mr. FOGEL. We know who the three are that lost and who got it. Yes, we do.

The CHAIRMAN. But do we have some sense of being able to reconstruct the reasons why they lost and why somebody else won?

Mr. FOGEL. No, we don't have detailed information on that.

Mr. BOWSHER. I think that, as I have asked my staff, the documentation for the 1988 transactions was just not developed too much. In other words, there was always the decision and somebody was awarded it, but sometimes they would say because more capital, sometimes because of management and things like that. But you didn't have any great analysis written down that we could examine.

The CHAIRMAN. But as a matter of sensible practice on a deal this size——

Mr. BOWSHER. Oh, it should be, you know, well-documented and the decision should be obvious to anybody that could come in and review it.

Mr. FOGEL. All we have is the final information. We don't have any documentation that shows how FSLIC arrived at the decisions that they did.

The CHAIRMAN. Isn't that unusual?

Mr. BOWSHER. Very unusual.

The CHAIRMAN. Had you anticipated that or did you think that when you went in you would find some kind of an audit trail that would lead to a decision on this scale that you could take a look at?

Mr. FOGEL. I think we anticipated that there would be more documentation in a form that we could follow.

Now, we had asked not just for information on this bidding process, but a lot of information dealing with some other aspects of these deals, which we finally got late last Friday, you know, after FSLIC took weeks to really just try to pull it together for us because they had to find it, too.

But in this case there just wasn't documentation that we are aware of that shows how they arrived at the final numbers.

The CHAIRMAN. So it is a mystery as to why somebody won and why others lost as the record has been developed thus far; is that a fair——

Mr. BOWSHER. I think that is a fair statement.

The CHAIRMAN. Now, I am concerned in the absence of that kind of record, which should be there. It is a multibillion dollar deal that obligates the Government and the taxpayers for a lot of money into the future. So, at a minimum, I think there is a requirement that if there is an orderly process, there ought to be some record of what it is. I am very disturbed about the fact that there is no record in this case. You have gone in and asked for it and you have not been able to find it.

I saw an article the other day in the January 31 Wall Street Journal about a fellow who goes out and is a private attorney that helps put deals together. He has been very successful, apparently, according to this article, if it is accurate, and last year he did about $12 million in billings from his work in helping to arrange 55 thrift mergers and acquisitions.

Now, this particular individual—and I am going to put the article in the record—his name is Mr. Vartanian—used to work at the Federal Home Loan Bank Board. And after a period of time went into private practice and began to help put these deals together, and he obviously seems to have a unique skill at doing it because he seems to do more than anybody else.

That may or may not mean something that would be a matter of concern, but I am interested enough because there isn't much of a record in terms of how these decisions are made as to what may be going on here that is causing somebody to win and others to lose.

Would you have any way of knowing whether he was involved in that particular deal?

Mr. BOWSHER. We could go back and check, but we don't have that information here today.

The CHAIRMAN. If we were to find whether this individual or somebody else was somebody that was in the center of a very large number of these deals, should we draw any conclusions for that or should we raise further questions about it?

Mr. BOWSHER. Well, I would think if we found that many of his clients were successful in the deals and many others weren't, then you might well want to have some kind of a hearing or do something that would just ask the question, how come this gentleman's clients were so successful and others weren't?

[The following news article from the Wall Street Journal and a response to the article from Thomas Vartanian are submitted for the record:]

WALL STREET
JOURNAL 1-31-89

Revolving Door

S&L Mess Isn't All Bad, At Least for Lawyers Who Were Regulators

Vartanian, Who Eased Rules For Thrifts, Bills Millions On Takeovers of Sick Ones

A Bonanza for Fried Frank

By JILL ABRAMSON
Staff Reporter of THE WALL STREET JOURNAL

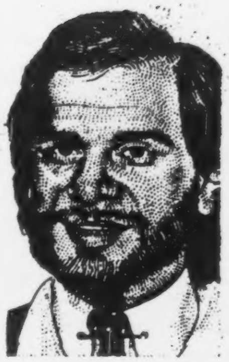
WASHINGTON – The savings-and-loan industry will long remember 1988 as a year of disaster. But it was Thomas Vartanian's best year ever.

Six years ago, Mr. Vartanian was general counsel at the Federal Home Loan Bank Board, helping write laws and rules that freed thrift institutions from decades of regulatory constraints. Thanks partly to the reckless way some S&Ls were soon using that freedom, the U.S. now faces a bailout bill that could hit $100 billion, and one might expect Mr. Vartanian to be squirming these days.

Wall Street Role

The thrift crisis plays naturally to investment banks' skills in raising money for recapitalizing sick thrifts, and the battle among firms for position is getting brutal. Meanwhile, the Treasury's rescue plan has sparked controversy, but the proposal or something like it is needed. Stories on pages C1 and B1.

Instead, he is prospering amid the crisis. As a partner at the law firm of Fried, Frank, Harris, Shriver & Jacobson, he generated a staggering $12 million in billings from his work in 55 thrift mergers and acquisitions–many of them involving institutions that crashed and burned in the new deregulated climate.



Thomas Vartanian

The nation's savings-and-loan bust has been a boom for S&L lawyers here, most of whom, like Mr. Vartanian, used to regulate the institutions. While no one blames regulators for the entire S&L calamity, many critics charge that the bureaucrats were, at the least, asleep at the switch when the industry's problems were developing. They find it galling that some of those same people are today among the big winners from the industry's predicament.

"It's easy to see how the public would see this as a particularly obscene example of people coming back to benefit from their actions in government," says Edward Furash, a banking analyst here.

"Everyone says they feel sorry for the people at the Bank Board," adds Rep. Jim Leach of Iowa, a Republican member of the House Banking Committee. "My impression is that they'll all go out and earn a million dollars. The revolving door at the Bank Board makes the problems at the Pentagon look like peanuts."

Not Our Fault

Mr. Vartanian, a short, bearded man who favors expensive three-piece suits, suspenders and Italian leather slip-ons, strenuously denies that deregulation was a cause of the industry's travails. "Deregulation did not cause the problem," he contends. "Failure to deregulate in the 1970s caused the problem."

And he sees no incongruity between his former activities and his current ones. "People don't come out of a regulatory agency in Washington and become a plumber," he says.

Indeed they don't. Mr. Vartanian's deputy when he was a thrift regulator, Patrick Doyle, now has a thriving S&L law practice at Arnold & Porter here. The man who succeeded Mr. Vartanian at the Home Loan Bank Board, Norman Raiden, does similar work as a partner at McKenna, Conner & Cuneo. The thrift group at the law firm of Jones, Day, Reavis & Pogue includes no fewer than seven former regulators at the Bank Board.

The thrift bar's high-paying clients include on occasion even the government itself. For 1988 alone, the Bank Board and the Federal Savings & Loan Insurance Corp., though they have 200 in-house attorneys, are paying $110 million to outside law firms for work arising from liquidations, management takeovers, mergers and acquisitions. Three law firms billed over $6 million each for such work.

A List of Clients

At age 39, Mr. Vartanian is to the savings-and-loan bar what Donald Trump is to real estate: a powerful deal-maker with a flair for self-promotion. In a profession where client relationships are traditionally kept confidential, he happily hands out a brochure listing 78 clients and 134 transactions for which he has arranged financings, mergers, acquisitions or reorganizations.

Since he joined Fried Frank, Mr. Vartanian estimates, the firm has been asked to represent the acquirer, the target or the underwriter in fully 75% of all thrift acquisitions valued at more than $50 million. "He's been an extraordinary success," says Arthur Fleischer, the firm's top mergers-and-acquisitions partner. Harvey Pitt, a partner who helped lure Mr. Vartanian to Fried Frank and now co-manages its 110-lawyer Washington office with him, jokes that "I should have insisted on a finder's fee."

In December, Mr. Vartanian and his team of 25 lawyers had their meters running for 13 groups seeking to acquire insolvent thrifts in the end-of-the-year fire sale conducted by the Bank Board. In the week between Christmas and New Year's, three major thrift-industry executives—none aware of the others' presence—were nervously camped out in his law firm's conference rooms, waiting to hear whether their bids had been accepted.

Mr. Vartanian's high-powered practice offers a stark contrast with his legal beginnings. In 1972, while working as an underwriter for Aetna Life & Casualty Co., he enrolled in evening classes at Brooklyn Law School. After earning his degree but being rebuffed by private firms, he landed a staff attorney's job with the federal comptroller of the currency. A 1980 assignment, involving a bank merger in Utah, turned out to be a lucky break.

The expert witness for Mr. Vartanian's side was Richard Pratt, then a professor of finance at the University of Utah. Mr. Pratt was impressed by Mr. Vartanian's intensity—"he wouldn't even take time off to come to our house for a Sunday dinner"—and when Ronald Reagan named the professor to head the Bank Board a year later, he tapped Mr. Vartanian to be his general counsel.

"I didn't know what an S&L was" at the time, Mr. Vartanian says. Nonetheless, with deregulation a Reagan administration priority, he soon was writing legal opinions that broadly affected the industry. One, for instance, permitted thrift institutions to enter the securities-brokerage business. He also wrote key provisions of the 1982 Garn-St Germain Act deregulating the industry, giving thrifts far broader lending powers—and, critics charge, opening the door to the carnage to come.

"Vartanian was for giving the thrifts powers without limit and no real supervision," charges Richard Still, a former staff director of the House Banking and Financial Institutions subcommittee. "Now we're all paying the price."

Though Mr. Vartanian was at the Bank

Board for only a little more than two years, he was the most visible general counsel in its history. Following the passage of deregulation legislation, he hit the road, giving razzle-dazzle speeches to an array of thrift-industry groups and potential investors. Some of his colleagues and listeners felt he was also doing a little selling of himself.

"He was into self-aggrandizement," asserts Ernest Leff, a Los Angeles thrift attorney who heard several of Mr. Vartanian's presentations. At the Bank Board, some colleagues nicknamed Mr. Vartanian "Doggie in the Window."

Edwin Gray, a former Reagan press spokesman who succeeded Mr. Pratt as Home Loan Bank Board chairman in May 1983, says he was "quite concerned" about Mr. Vartanian's appearances before industry groups. "Mr. Vartanian seemed to me to be seeking clients for after his departure," Mr. Gray says.

Mr. Vartanian, though, vehemently denies soliciting future clients while he was in the government. With his speeches, he says, he was merely "hawking the thrift charter" at Mr. Pratt's urging in an effort to attract new capital to the troubled industry. "Every minute of every hour I tried to make the best impression I could," he says. "It would have been naive not to."

After Mr. Pratt left the chairmanship to take a job at Merrill Lynch, Mr. Vartanian says, it quickly became clear that he couldn't work with the new Bank Board chief, Mr. Gray. Looking back, Mr. Vartanian says, he left before certain deregulatory safeguards—such as clamping down on state-chartered institutions, increasing capital requirements and bolstering the board's supervisory staff—were put into place. "The mistake was not staying long enough," he says. "The second part of deregulation was strengthening supervision. Unfortunately, we never got to it."

Deregulation's real impact on the thrift industry, Mr. Vartanian believes, was to ignite an explosion of mergers and acquisitions. "An S&L charter became the most liberal charter of any financial institution," he says. Of course, the new investors flooding into the business all needed lawyers to negotiate their deals and get them approved by the Bank Board. Mr. Vartanian's knowledge and contacts—he claims he left the Bank Board conversant "with the financials of every S&L in the country" and "knowing every thrift executive"—made him a hot commodity. Before deciding on Fried Frank, he got offers from 25 other law firms.

Within a week of his arrival at the firm, Mr. Vartanian had three clients signed up. One was City Federal Savings & Loan Association of Bedminster, N.J. Four months earlier, while still at the Bank Board, Mr. Vartanian had written a legal opinion that permitted City Federal to mount a successful $28 million hostile takeover bid for another S&L, Home Federal of Palm Beach, Fla. The sweeping opinion said parties attempting to buy a publicly traded thrift no longer had to get advance approval from the board.

Ronald Tell, City Federal's general counsel, says he was impressed with regulator Vartanian's "innovative" opinion on the acquisition, and it was only logical that the company would want to sign up with him when he went into private practice. "He's a legal dynamo," says Mr. Tell. "You give him a project and you know you'll get results."

Although ethics laws barred Mr. Vartanian from lobbying with anyone at the Bank Board for a year after he left it, he had no problem attracting other clients. He maintained a high profile, writing articles and making speeches. When the year was up, he was able to begin dealing with his old agency, and clients now say he still has a lot of clout there.

"He can pick up the phone and call anybody," says H.M. Osteen, chairman of Bankers First Corp. of Augusta, Ga. At Merrill Lynch, Mr. Pratt says he uses Mr. Vartanian's services at least every 10 days. Goldman Sachs partner John Oros says he may use him even more often than that.

About half of the deals Mr. Vartanian has orchestrated involve healthy thrifts;

the other half are for either sick or insolvent ones and must be negotiated with aid from the Bank Board. In the rush of activity at the end of last year, Mr. Vartanian successfully negotiated with the board the acquisition of two failing thrifts by Pacific First Federal Savings Bank of Seattle, the purchase of Beach Federal S&L by Golden West Financial Corp., and a bid for Tahoe S&L by First Network Savings Bank of Los Angeles.

The assets involved in these takeovers totaled more than $2 billion. The few big deals Mr. Vartanian has missed have usually been off-limits because of conflicts; he couldn't work on the Financial Corp. of America deal, for example, because he had represented a previous bidder, former Treasury Secretary William Simon.

Mr. Vartanian began 1989 just where he left off last year. He is involved now in some 36 thrift deals involving $2.3 billion, including several federally assisted acquisitions that didn't get Bank Board approval in 1988 but are still pending.

Mr. Vartanian is amused at the contrast between his current highflying life style and his more modest origins. He grew up in a middle-class Armenian-American family on New York's Long Island, where his father was a postmaster. After high school, he attended a seminary college, intending to enter the priesthood. Though he weighed 200 pounds and stood barely more than 5 feet 6, Mr. Vartanian was an avid basketball player and made the seminary team.

These days, the now-trim lawyer works out twice a day in a gym in the basement of his sprawling estate in suburban McLean, Va., where his neighbor used to be Defense Secretary Caspar Weinberger. And in his office at Fried Frank hangs a giant lithograph by the realist painter Richard Estes, showing a New York City D-train making its way across the Manhattan Bridge. Mr. Vartanian keeps it there to remind him of all the years he spent taking the subway between his day job in Manhattan and the law school in Brooklyn. "It keeps me humble," he jokes.

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March 30, 1989

Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
  Housing and Urban Affairs
United States Senate
105 Dirksen Senate Office Building
Washington, D.C. 20510-6075

Dear Chairman Riegle:

Your office was very gracious to provide me with a copy of the transcript of the Committee's hearings on Tuesday, March 14, 1989, in which you made reference to an article about me in The Wall Street Journal on January 31, 1989. Having now reviewed that transcript, I would like to supplement my letter to you of March 15, 1989 (a copy of which is enclosed), and respond to the erroneous impressions left by the Journal article and the specific questions you raised in the hearing.

Fried Frank's practice involving banks and savings and loans, has principally involved, by a wide margin, the representation of healthy, publicly-owned institutions (banks and thrifts) and other companies interested in acquiring such healthy institutions with no financial assistance from the FSLIC. In that respect, our records indicate that the firm was lead counsel to successful bidders before the FSLIC in only three (not 55) of the 189 FSLIC-assisted transactions completed by the FSLIC in 1988. None of these transactions involved institutions in Texas or institutions otherwise handled under the FSLIC's Southwest Plan. Two of these three transactions were handled, in whole or in part, by two different regional Federal Home Loan Banks under delegated authority. In comparison to the large, well-publicized transactions completed by the FSLIC in 1988, the three transactions in which this firm was involved were relatively small.

Additionally, with respect to the Journal article, objectivity would suggest a more balanced perspective regarding the reference to me as a revolving door regulator. As I have previously indicated, I was a civil servant for the first seven years of my legal career after law school before joining Fried, Frank in 1983. I am not an example of an official who moved in and out of government between personal endeavors involving the banking and thrift industries. Moreover, my documented record is one demonstrating strong concern for the state of the savings and loan industry both during and after my service in the government. (Incidentally, the Journal erroneously reported that I received 25 offers from law firms when I left the Bank Board. The correct number, as best that I can recall was 2.)

As the general counsel of the Bank Board under Chairman Richard T. Pratt, I served a Bank Board that was hailed for its unprecedented efforts to (1) close and recapitalize failed institutions (434 in 3 years, compared to 165 in the prior 45 years); (2) reduce the cost of rescuing failed institutions from 70% of the cost of liquidation between 1978-80, to 16% in 1982; (3) upgrade an antiquated supervisory system by increasing, between 1980 and 1983, enforcement actions by five times and director and officer removals by 20 times; and (4) initiate a program to pursue litigation against the management of failed institutions (12 suits were filed in 1982 alone, compared to one in 1979 and one in 1980).

However, as the agency's general counsel, I did not make Bank Board policy decisions regarding deregulation of the savings and loan industry, many of which were dictated by the Congress and the Administration, and did not have any substantive role in the development or liberalization of Bank Board accounting or regulatory reporting requirements adopted by the Bank Board.

In addition, I would note that the reference to 55 transactions in the Journal article includes a variety of legal work (e.g., mergers, acquisitions, reorganizations, recapitalizations and responses to actual or anticipated unsolicited acquisition offers of publicly held institutions). As I previously have indicated, this work, by a wide margin, involved the representation of clients in transactions dealing with healthy banks and savings and loans associations involving no financial assistance from the FSLIC. It should also be noted that that number also includes transactions in which the firm represented thrift and non-thrift clients where agreements were never reached between the parties and, therefore, were never filed with regulatory authorities. As mentioned above, the firm represented acquirors before the FSLIC in only 3 transactions in 1988 which were financially assisted by the FSLIC. Finally, there is no correlation whatsoever between the 55 bank and thrift merger and acquisition assignments the firm was reported to have acted in and the fees purportedly paid to the firm in 1988.

More specifically, with respect to the Committee's hearing, at page 92 of the March 14 transcript, you inquired whether this firm had been involved in the representation of Mr. Pearlman with respect to his acquisition. Neither I nor this firm were in any way involved in the representation of Mr. Pearlman or his associates in that matter.

At page 98 of the transcript, you asked whether this firm had been involved in the representation of Mr. Bass with respect to his acquisition. Neither I nor this firm were in any way involved in the representation of Mr. Bass or his associates in that matter.

At page 98, you questioned whether this firm had been involved "in 55 of these thrift acquisitions." I have already explained the derivation of the reference to "55" transactions and mentioned that this firm was lead counsel to successful bidders in FSLIC-assisted transactions in only 3 cases in 1988.

Finally, at page 99 and 110, you inquired regarding whether certain individuals "had any kind of an inside track" in completing FSLIC assisted transactions and also referenced my appointment to the Federal Home Loan Bank Board's Advisory Council. As an ex-officio member of the Advisory Council for the first time in 1988, I served, with the authorization of the Office of General Counsel, with among approximately 40 other individuals. In 1988, the Advisory Council included approximately eight other lawyers, some of whom have also been previously employed by the Bank Board, whose firms either have active savings and loan practices or are currently engaged by the FSLIC. Fried, Frank has not represented and does not represent the FSLIC or FDIC. In any event, I assume that the fact that this firm was the principal counsel to acquirors in only three FSLIC assisted transactions completed in 1988 speaks for itself with respect to this firm's activities.

I note that at page 92 of the transcript you introduced the Journal article into the record. Given the unfair and erroneous impressions that it leaves, I would appreciate it if you would consider including this letter, my enclosed letter of March 15, and the enclosed piece entitled "Managing a Financial Crisis: The Record of the FHLBB 1981-83" in the record.

I continue to share your concerns for the state of the savings and loan industry and applaud the leadership that you have demonstrated in attempting to develop a workable solution to what is a very complex and multifaceted problem. If I can be of further assistance to the Committee or its staff, you should feel free to call upon me.

Sincerely,

Thomas P. Vartanian

Enclosures
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The CHAIRMAN. As the story reads—and I have no independent knowledge other than what is in this particular article written by writer Jill Abramson, but it sounds as if this particular individual has wonderful access at the Home Loan Bank Board and is able to get phone calls returned.

You mentioned somebody else that you interviewed who thought that they were on the track to become a finalist in an acquisition all of a sudden found that they couldn't get their phone calls returned.

Am I remembering your testimony accurately?

Mr. BOWSHER. You are. That is right.

PREFERRED TREATMENT?

The CHAIRMAN. Well, it sounds like some people get their phone calls returned more readily than others, and I am very troubled about that. I think there is an accountability that everybody that is on the line has to step up to in terms of if we have arrangements of that kind or even the appearance of arrangements of that kind—particularly if we are talking about people who previously worked at the Bank Board. It seems to me that even creates more of a problem of an appearance.

I have had others come and indicate that they felt as if the process that went on wasn't necessarily a fair process.

Let me take you for a minute over to the Bass deal in California. Have you looked at that one as well?

Mr. FOGEL. Yes, we did look at that.

The CHAIRMAN. Now, as I understand the Bass deal, it changed a number of times over a period of months. At one point the package was put out to potential acquirers in one form and then, if I have it right—and correct me if I am wrong—at some point the Bank Board decided that they would come down to a single preferred bidder, in this case the Bass Group, and that they would pursue the issue hopefully to conclusion. But the package kept changing materially, and what was being talked about underwent such major changes that one might argue that people who were left out might reasonably say that they were invited out on the basis of one kind of package when, in fact, later it turned into a very different package. Therefore, they would argue that they should feel able to be reconsidered on the basis of the fact that the package had undergone a fundamental change from the time at which they were invited out.

Do you have enough information to be able to judge as to whether that kind of a circumstance was taking place in that case or in others like it?

Mr. BOWSHER. I can certainly say it was in others. In fact, that was part of my illustration earlier, and that is that lots of times you repackage the deal several times and then when you finally went to your final negotiation you didn't let the other people have another opportunity.

So there is no question that this was a pattern that bothered us as we reviewed these deals.

Now, on this one particularly I will have Dick describe what happened.

Mr. FOGEL. Yes. There were indications that the Bank Board, first of all, retained Salomon Bros. to try to locate an acquirer for Old American, and its initial efforts were really unsuccessful to try to provide an acquirer. They then did eventually pursue negotiations with four interested parties, and a proposal from one of the parties was seen as the best alternative. And that was about in mid-December 1987. Negotiations were suspended, though, because they couldn't reach an agreement.

So then they did go out and talk to some other groups, and one of the groups that expressed an interest was the Bass Group, and their interest was pursued and extensive negotiations were undertaken with the Bass Group.

In early April 1988, the discussions with Bass seemed sufficiently promising so that the acquisition was raised with the Board for its preliminary consideration.

However, at that time another group came in and expressed renewed interest in the deal and apparently was willing to compromise on demands that it had made in December that led to it being thrown out.

So I think in this case you have got to realize it is a negotiation and, you know, one group said they didn't want to have certain things in the contract and the Bank Board, had to walk away.

So I don't think you can criticize just the Bank Board on this deal because it really is a negotiation process, and the way the statute reads they have a fair amount of flexibility in trying to negotiate these deals. So there were some tradeoffs trying to be made here.

So it is not really a clear black and white situation that all of these people who were interested and didn't get a deal deserved to get it, and I think what we would have to do is go in and do more work in detail to try to interview more people to see exactly why they made the decision.

The CHAIRMAN. Well, I think that needs to be done. For the amounts of money that are involved and the fact that there is not a clear record, I think we have to reconstruct the record after the fact and make sure it was proper.

Now, do you have any sense of knowing whether Mr. Vartanian was involved in that situation?

Mr. FOGEL. We don't know.

The CHAIRMAN. You don't know.

Would you make the inquiry and find out?

Mr. FOGEL. Yes, we will find out.

The CHAIRMAN. Now, I am told that Mr. Vartanian was both the general counsel to FSLIC in earlier days and the general counsel to the Bank Board, just by way of historical record.

Mr. FOGEL. Yes.

The CHAIRMAN. Again, that doesn't lead to the fact that somehow he has special access, but I think it raises the question that has to be answered as to whether, in fact, he does or others like him do when in fact, according to this story he is just one private lawyer who managed to be involved in 55 of these thrift acquisitions. It certainly sounds odd in the absence of the kind of careful recordkeeping that one would normally expect to find in multibillion dollar deals like this. If you see odd patterns emerge where somebody who has a past connection is doing a huge volume of this business, that it just doesn't look right. It just doesn't look right, and it doesn't look right to me.

I am also told that this particular individual, after he left the Federal Home Loan Bank Board was selected to sit on the FSLIC Advisory Committee while he was in the private sector presumably also doing this kind of work for private clients and doing deals with the Bank Board apparently more successfully than anybody else.

But these are the kinds of things that it seems to me we have got to get the sunshine to come in on to find out exactly what did take place, and especially because the amounts of money that we are talking about are absolutely extraordinary. They are amounts that our constituents are going to have to pay for. It is just excessive in a situation like this.

But it appears to me that things took place here that, to those that were directly involved, didn't seem excessive, or at least seemed necessary and something that we ought to think of as sort of the normal course of what had to happen.

Mr. FOGEL. That is correct, Senator, and that is why it is absolutely critical in these reforms that we separate the insurance function from the Bank Board and everyone else. You cannot have this relationship continue where you have got the group that is really representing the industry responsible for overseeing the safety and soundness of these institutions and then trying to take the action to work ~~us out of~~ the problem.

The CHAIRMAN. I want to yield to my colleagues, and then I may come back.

Senator Bryan.

Senator Graham.

Senator GRAHAM. Between what dates were the transactions that you analyzed for the purposes of this report negotiated?

Mr. BOWSHER. Well, they were all in the 1988 deals, and some of them—let's see, how many?

Mr. FOGEL. Some of the negotiations started in 1987.

Mr. BOWSHER. Yes. So it all took place literally in——

Mr. FOGEL. 1987 and then the deals were all consummated in 1988.

Mr. BOWSHER. 1988, yes.

Senator GRAHAM. Based on what you have learned of these 12 transactions, could you give me your assessment of this statement which was made by the Chairman of the Home Loan Bank Board during apparently the midst of this, September 8, 1988?

He stated:

> I believe that in the past year FSLIC has made significant strides in resolving FSLIC cases and, though subject to the vagrancies of future economic conditions, realistic projections today indicate that FSLIC possesses adequate resources in the near term to deal effectively with the immediate problems of troubled institutions.

Would you have made that statement on September 8, 1988?

Mr. BOWSHER. No. No, I wouldn't have. In other words, I think that is what led to the problem here, that there was a willingness to do these deals without waiting for a congressional package where you would actually have some real money and some real capability to do the deals, and I think that that is where the mistake was made.

Also, I think, of course, when you do the deals before the legislation is passed you then don't get the reforms up front.

Senator **GRAHAM**. If you were sitting on our side of this room and you had heard that statement, would you be energized to come forth with a congressional salvation plan?

Mr. **BOWSHER**. Well, I think what should have been requested by the past administration was, one, a recognition of what the problem was and a request for a plan, that is right.

Senator **GRAHAM**. So the answer to the question is "No."

Mr. **BOWSHER**. Yes. [Laughter.]

I am not quite sure I did get the question.

Senator **GRAHAM**. The question was, what would the statement which contained the phrase "realistic projections today indicate that FSLIC possesses adequate resources in the near term"——

Mr. **BOWSHER**. Oh, yes. I would not have said that.

Senator **GRAHAM** [continuing]. "To deal effectively with the immediate problems of troubled institutions"—if you had been sitting in the chairman's chair and had heard that statement, what would have been the normal expected response, one of heightened energy that we have to——

Mr. **BOWSHER**. Well, I think that has been one of the real problems—in other words, a lot of people blame the Congress here, and there is no question, I think, that Congress has to share some of the blame for this problem, but I think one of the big problems that Congress had was that the administration and the witnesses coming before it, including the industry witnesses, were not willing to acknowledge that there was a problem, and therefore you had no plan that was coming forward saying we need this large sum of money to deal with this problem.

We did have it 2 years ago and actually a lot of people, especially in the industry, hammered that one down from $15 to $5 billion. So that was one of the great dilemmas that the congressional leadership I think was facing, and that is without recognition of what the problem is how do you deal with the problem?

It is also a difficult period, I think.

Senator **GRAHAM**. Thank you.

The **CHAIRMAN**. You know, the more I look at the situation of who got to do the deals and who didn't and who has gotten rich in the process and who hasn't, I think there are some very troubling appearances, at the very least, in this situation.

LACK OF ADEQUATE RECORDKEEPING

Now, I want to go back to the recordkeeping that was done at the Federal Home Loan Bank Board, that as you have gone in to perform these audits at the request of this committee, I want to spend a little more time on exactly what you found. I take it that there just isn't much in the way of formal records regarding the unfolding of these decisions, is that right?

Describe, as fully as you can, what you have found as a general pattern, and also, I would like you to put beside that some reasonable standard of what one might expect to find in a case like this.

Mr. FOGEL. I think our staff, from the records that we were able to go through, was able to reconstruct the general process that took place in each deal in terms of timing, who was in, who was out.

What wasn't really available was the rationale and analysis that led us to fully understand the conclusions that were reached in the decisions to give the deal to, you know, bidder A as opposed to bidder B. But the information was there to generally reconstruct.

I don't want to absolutely compare how this process would work to a Government contract because I want to emphasize the rules are different. The statutory basis for soliciting bids in FSLIC is not the same as in a regular Government contract. But generally we would expect a fairly well-documented record that says, well, you had these four bidders and here is why we really decided to pick bidder B instead of the others.

So the information was generally there. There was information, for example, that showed when the FSLIC people were going through to see whether the people had enough capital or whether their management of a thrift was adequate they would say we didn't think these bidders had sufficient capital or we didn't think these people were managerially well-qualified enough to run a thrift.

But what we didn't see was documentation behind that to support the conclusion that they reached.

The CHAIRMAN. Now, I take it that surprised you; you expect that you would find that in deals of this scope and magnitude?

Mr. FOGEL. Yes.

Mr. BOWSHER. You know, we run a bid protest function over at GAO, and that means that anybody that does a Federal procurement, that partakes in a Federal procurement that is a loser, they can protest to the GAO, and what we do there—we never make the decision as to whether it should be airplane A or airplane B as the better airplane. What we do is we review the process, and at that point, the people have to come forward with all their records and they have to show us how they did it. One of the normal Federal procurement policies is that deciding officials must write a written justification for their decisions and then we go behind that and look for what are the schedules and how did you arrive at, and everything like that.

The CHAIRMAN. Right, right.

Mr. BOWSHER. And that is what we were looking for.

The CHAIRMAN. But you found no written explanations?

Mr. BOWSHER. Sometimes we found some written justification. I wouldn't say that we didn't find the summary justification, but what we didn't find lots of times was the analysis and the detail.

The CHAIRMAN. Which really support the judgment that was made?

Mr. BOWSHER. That is right, yes.

The CHAIRMAN. Have you gotten every scrap of information you have asked for?

Mr. BOWSHER. We are not sure. That is one of the things that worries us, and as Dick said, they just delivered an awful lot on another topic this past week that we had asked for, and we haven't been able to sift through all of that.

The CHAIRMAN. What was the reason given for why it has taken them so long? You sent the request how much earlier than that?

Mr. BOWSHER. Well, we sent it—we met with them as soon as we had your request, Senator.

The CHAIRMAN. So that would have been at the end of last year?

Mr. BOWSHER. Yes. That is right, after we got your December 30 letter.

The CHAIRMAN. So you met with them, you made the request in December?

Mr. BOWSHER. A good while ago.

The CHAIRMAN. And a very large volume of information arrived Friday of this last week.

Mr. BOWSHER. Yes, an another topic.

Mr. FOGEL. Dealing with certain aspects of the deals, basically dealing with some of the forbearances.

Our staff has volumes of information. Part of the problem, I think, is that because a lot of these deals were put together so quickly at the end of December FSLIC hasn't had time to get it organized properly either.

One other thing I want——

The CHAIRMAN. Well, they shouldn't have to.

Mr. FOGEL. That should have been done as they were doing the deals.

The CHAIRMAN. Yes. They should have organized it properly before they made the decisions——

Mr. FOGEL. That is correct.

The CHAIRMAN [continuing]. And put the Government on the hook. We shouldn't have to go in now and through a frantic effort try to reconstruct bits and pieces of why something was done.

Mr. FOGEL. That is correct.

The CHAIRMAN. I mean, the whole point of the exercise is to do that before the decisions are made.

Mr. FOGEL. One of the—the staff just passed me a note. I guess another thing I forgot to mention in one of the deals, the Perelman deal, the Blackstone Group was partly responsible for analyzing that. So they may have some additional evidence in New York that we haven't pursued yet to see why they recommended the decision they did.

But there you had a private group doing the analysis, recommending to the Government what to do. But we didn't find anything in the FSLIC's files that satisfied us.

The CHAIRMAN. With respect to the volume of information you received on Friday, I assume people have been working on that over the weekend to try to get it in some semblance of order so that you would be ready for today's appearance, which has been scheduled for some time.

Is it your intention to continue to work through this material to make as much sense out of it as we can?

Mr. BOWSHER. Yes.

The CHAIRMAN. If you need additional help, I hope you will let us know because I want to know what happened. We are not going to just let this thing slide by because it is behind us. I intend to know as fully as we can figure it out what happened and what didn't happen and have it out on the public record.

Mr. BOWSHER. What I would suggest, Mr. Chairman, is that we will give you the additional information on some of these other issues that you have asked for today, and then if there are any additional things that come to our attention in pursuing the documentation we would include that.

DIFFICULTY IN OBTAINING INFORMATION

The CHAIRMAN. This isn't the first time we have had that problem. We had one situation arise with respect to asking for information as we were reading about it in the newspapers.

We had a rather heated exchange one day in the Senate Budget Committee on these issues trying to get information out of the Federal Home Loan Bank Board and found it very difficult to do, and so others of us have had that experience ourselves.

We are going to leave the record open because I want the Bank Board to offer any comments that they may have, and we may have a number of additional questions for them to respond to with respect to this.

But I would like you to notify me immediately if anything you ask for you don't get on a timely basis.

Mr. BOWSHER. All right. We will do that.

The CHAIRMAN. I don't want any delay, and if there is a single sign that you are not getting what you ask for, I want to know it and this committee will take that up immediately because I think anything you ask for you are entitled to have. I want you to have, and I want you to analyze it thoroughly so that by the time you are done with your analysis we understand what took place as clearly as we possibly can.

I am concerned about whether or not there were patterns of favoritism that were followed here, because somebody had an inside track or private lawyers or others—I have cited the story in the Wall Street Journal.

When I read here, if these facts are right, that this one individual and his team was involved in 55 thrift mergers and acquisitions, that seems awfully high to me. I want to know better, especially because there is this absence of the kind of orderly record of decisionmaking that one would expect to find, exactly how these decisions were made and whether people in outside situations were somehow interdicting this process and having an effect on it.

I feel very strongly about it. I want to get the answers, and I don't want to see us say as a government, you know, we just can't find out.

I don't buy that. I think we can find out and we have an obligation to find out.

So I intend to see that we continue with it till we do.

Senator Graham, did you have anything else you wanted to raise at this point?

Senator GRAHAM. I have no further questions. I would just like to comment that I am pleased to see the chairman's rising sense of moral outrage.

It disturbs me that we have viewed this issue as being one as mechanics who have a broken engine and it is our job to try to carefully diagnose the problem and put in the appropriate valves and screws and washers to repair the problem.

I think we have nothing less here than a scandal that dwarfs virtually any other in our Nation's economic history, and I believe the tone of moral outrage which you are injecting in this hearing is absolutely appropriate, and I believe that it should be a tone that should be a significant part of our actions from now until we take a bill from this committee to the Senate floor.

The American people have every right to feel as if they have been ravaged by this circumstance. There are many who participated in this gang ravage operation. It is our job to not only see that it doesn't happen in the future, but that those who have contributed to it are held to account.

The CHAIRMAN. Let me say one other thing before we finish today.

We are going to have other questions that we would like to have you answer for the record, but I appreciate your agreement today to help us take a look at this alternative way to handle the financing.

Mr. BOWSHER. Yes.

The CHAIRMAN. This is a very important point, and time is short on that, and I know you are under a lot of pressure to do a lot of things but that could be very helpful to us, and we could end up potentially saving a lot of money if we can find a sensible way to do that.

Let me have order in the committee room.

I want to say one other thing, and that is when I asked you officially to conduct that audit on these December deals, we did it before the end of the year, and the Federal Home Loan Bank Board, because you notified them, if I understand it, essentially immediately, they were on notice. They were on notice that we were going to take that kind of a look through the General Accounting Office.

So in a sense, the fact that the records are as incomplete as they are I think is even more inexcusable because they clearly were on notice of the fact that there was intense interest about these deals and why they were being made and what the basis for the decision was.

So to now find, in going back, and even getting this information, as much of it as you did, on Friday, I don't think that is an acceptable way to respond to this problem. I think they are going to have to move a lot faster and get their information together in a much more orderly fashion, and there really isn't any other acceptable course of action, as I see it.

So we will continue with this.

I want to thank you and your auditors for the work they are doing. I know these are complex puzzles to put together.

Mr. BOWSHER. Yes.

The CHAIRMAN. But stay on it. This committee intends to complete this record in this area no matter how long it takes.

Mr. BOWSHER. Right, and we will keep you informed, Mr. Chairman.

The CHAIRMAN. Very good.

Mr. BOWSHER. Yes.

The CHAIRMAN. Thank you. The committee stands in recess.

[Whereupon, at 12:35 p.m., the committee was adjourned subject to the call of the Chair.]

[Response to written questions and additional material supplied for the record follows:]

GAO United States
General Accounting Office
Washington, D.C. 20548

General Government Division

G9-0121

April 7, 1989

The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing, and Urban Affairs

The Honorable Alan Cranston
Member, Committee on Banking,
Housing, and Urban Affairs
United States Senate

This letter responds to your March 14, 1989 joint request that we answer 11 questions relating primarily to activities of the Federal Deposit Insurance Corporation. We have tried to be responsive to your need to receive this information prior to markup of savings and loan legislation by relying on prior work.

The questions and our responses are enclosed. We trust that the information will be useful to you. If you have any questions, please call me on 275-8678 or Alison Kern on 898-7196.

Craig A. Simmons
Director
Financial Institutions and
Markets Issues

Enclosure

7

Enclosure

RESPONSES TO SUBMITTED QUESTIONS

QUESTION 1: LIST THE 10 LARGEST FDIC LIQUIDATIONS SINCE 1980?

QUESTION 2: WITH REGARD TO THESE 10 TRANSACTIONS?

a. WHAT WAS THE CALCULATED ESTIMATE FOR THE COST OF EACH LIQUIDATION?

b. WHAT HAS THE FDIC'S EXPERIENCE BEEN TO DATE RELATIVE TO THE ESTIMATED COST OF LIQUIDATION?

ANSWERS 1 AND 2:

The following table lists the 10 largest liquidations, based on asset size as of the date the bank was closed. It provides data on receivership disbursements, collections, net estimated future collections (disbursements), and the estimated loss, as of year-end, for the year the bank failed and as of year-end 1988.

A liquidation was defined for the purpose of this response as any bank that failed between 1980 and 1988. First Republic is excluded because of the complexity of its resolution, which is discussed in response to question 8. However, any failed bank that was merged into a bank that subsequently failed or was given open bank assistance is not included in this table.

This table presents all receivership transactions, including all disbursements and receipts. For example, claims paid and receipts received from litigation are included.

Enclosure

FAILED BANK DATA
1980-1988

	BANK	TOTAL ASSETS AS OF FAILURE DATE	DISBURSEMENTS	COLLECTIONS	NET ESTIMATED FUTURE COLLECTIONS <DISBURSEMENTS>	ESTIMATED LOSS
A	Penn Square Bank, NA					
	Failed @ 7-5-82	$ 516,800,000				
	As of 12/31/82		$227,990,539	0	181,990,539	46,000,00
	As of 12/31/88		221,564,652	$151,275,778	1,486,990	68,801,884
	Net Change		($6,425,887)	$151,275,778	(180,503,549)	22,801,884
B	United American Bank in Knoxville					
	Failed @ 2-14-83	$ 778,434,000				
	As of 12/31/83		$186,446,803	178,000	(13,731,197)	200,000,00
	As of 12/31/88		510,715,748	$122,655,778	21,683,009	366,376,961
	Net Change		$324,268,945	$122,477,778	35,414,206	166,376,961
B	Girod Trust Company					
	Failed @ 8-16-84	$ 398,666,000				
	As of 12/31/84		$177,692,746	$ 15,066,187	115,400,559	47,226,00
	As of 12/31/88		229,220,788	107,838,193	23,199,859	98,182,73
	Net Change		$ 51,528,042	$ 92,772,006	(92,200,700)	50,956,73
B	Park Bank					
	Failed @ 2-14-86	$ 592,900,000				
	As of 12/31/86		$210,730,644	$ 28,482,704	64,743,174	117,504,76
	As of 12/31/88		287,756,462	113,988,175	82,878,935	90,889,352
	Net Change		$ 77,025,818	85,505,471	18,135,761	(26,615,414
B	The First Nat'l Bank & Trust of Okla. City					
	Failed @ 7-14-86	$1,600,000,000				
	As of 12/31/86		$708,516,169	$211,386,226	76,715,943	420,414,00
	As of 12/31/88		821,380,449	536,093,685	39,960,382	245,326,382
	Net Change		$112,864,280	324,707,459	(36,755,561)	(175,087,61
C	Capital Bank & Trust Company					
	Failed @ 10-30-87	$ 372,200,000				
	As of 12/31/87		$118,655,983	$ 1,551,395	(22,895,412)	140,000,00
	As of 12/31/88		74,141,871	9,453,712	14,640,414	50,047,74
	Net Change		$(44,514,112)	$ 7,902,317	37,535,826	(89,952,255)
D	Yankee Bank for Finance & Savings, FSB					
	Failed @ 10-16-87	$ 521,700,000				
	As of 12/31/87		$ 451,426,215	$ 0	377,468,242	73,957,97
	As of 12/31/88		456,485,086	296,792,051	81,108,017	78,585,01
	Net Change		$ 5,058,871	296,792,051	(296,360,225)	4,627,04

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	BANK	TOTAL ASSETS AS OF FAILURE DATE	DISBURSEMENTS	COLLECTIONS	NET ESTIMATED FUTURE COLLECTIONS <DISBURSEMENTS>	ESTIMATED LOSS
B	First Interstate Bank of Alaska					
	Failed @ 12-11-87	$ 375,400,000				
	As of 12/31/87		$ 135,714,582	$ 11,000,000	39,314,582	85,400,000
	As of 12/31/88		237,665,960	51,576,061	71,427,568	114,662,331
	Net Change		$ 101,951,378	$ 40,576,061	32,112,986	29,262,331
D	Western Bank - Westheimer					
	Failed @ 10-01-87	$ 290,900,000				
	As of 12/31/87		$204,179,513	$ 0	116,698,169	87,481,344
	As of 12/31/88		204,160,167	30,189,986	61,609,155	112,361,026
	Net Change		$ (19,346)	$30,189,986	(55,089,014)	24,879,682
E	Caribank					
	Failed @ 12-09-88	$ 535,800,000				
	As of 12/31/88		$ 48,392,222	0	7,456,280	40,935,942
	As of 12/31/88		48,392,222	0	7,456,280	40,935,942
	Net Change		0	0	0	0

Note: The amounts in the column "net estimate future collections (disbursements)" are based on present value calculations as of the date reported.

Footnote:

A = Deposit Insurance National Bank
B = Purchase and Assumption
C = Bridge Bank
D = Insured Deposit Transfer
E = Total Asset Purchase

SOURCE: FDIC General Ledger amounts.

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QUESTION 3: WHAT IS THE AVERAGE "LIFETIME" OF A FDIC RECEIVERSHIP?

ANSWER 3:

The life cycle of a bank liquidation - from failure of the bank to termination of the receivership - can vary considerably, depending primarily on the level of litigation involved and complexity of the assets. Before recommending termination to the court, FDIC considers factors such as the extent to which it, as receiver, has repaid the insurance fund for advances; how much more it might recover, net of expenses, including judgements; and any outstanding claims against the liquidation. Once the court agrees to the termination, FDIC proceeds with termination procedures.

In our 1988 report[1] we stated that as of March 31, 1988, 58 failed bank receiverships had been terminated since 1980. Almost 70 percent of the banks had failed before 1977. The average life of these liquidations was 12 years, while the range was from 4.3 to 23 years. During the remainder of 1988, over 190 bank receiverships were terminated, but we did not have comparable information on those receiverships.

QUESTION 4: HOW MANY PERSONNEL ARE TYPICALLY EMPLOYED IN A FDIC RECEIVERSHIP?

A. AVERAGE?
B. PER DOLLAR AMOUNT OF ASSETS?
C. PER ASSET?

ANSWER 4:

FDIC assigns personnel to specific receiverships only until records have been set up so that assets and records can be transferred to a consolidated office. The Division of Liquidation had about 15 consolidated offices, as of March 1989. Typically, 40 to 50 bank receiverships are assigned to a consolidated office, according to an FDIC official. At the consolidated office, the failed bank's assets are segregated by type and assigned to the unit specializing in that type of asset. As of March 1989, the consolidated offices were responsible for liquidating over 95 percent of the total book value of acquired assets.

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[1] Failed Banks: FDIC's Asset Liquidation Operations (GGD-88-132, Sept. 1988).

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At year-end 1987 FDIC Division of Liquidation employees totaled 4,357; 99 percent were located in the field. At year-end 1988, there were 3,386 employees.

QUESTION 5: WHAT IS THE TYPICAL ASSET MIX OF AN INSTITUTION PLACED INTO FDIC RECEIVERSHIP?

ANSWER 5:

The following table shows a break-out by type of assets, excluding cash and cash equivalents, held by FDIC in its receivership or corporate capacity.

FDIC Assets in Liquidation by Type
(February 28, 1989)
(millions, rounded)

	Book-Value	Percent of Total
Commercial loans	$5,339	57%
Mortgage loans	1,907	20
Judgements	523	6
Owned real estate and other owned assets	766	8
Other assets	358	4
Other	149	2
Installment loans	287	3
	$9,329	

QUESTION 6: WHAT HAS BEEN THE HISTORIC COST RECOVERY RECORD OF FDIC RECEIVERSHIPS IN TERMS OF THE FINAL PRICE RECEIVED ON ASSETS VERSUS THE ORIGINAL BOOK VALUE OF THOSE ASSETS?

QUESTION 7: TAKING INTO ACCOUNT ALL COSTS INCURRED IN THE OPERATION OF A FEDERAL RECEIVERSHIP INCLUDING PERSONNEL, OUTSIDE CONSULTANTS, LEGAL AND ALL OTHER OPERATIONAL EXPENSES, WHAT HAS THE FDIC'S HISTORICAL RECOVERY RECORD BEEN IN RECEIVERSHIPS SINCE 1980, RELATIVE TO THE ORIGINAL BOOK VALUE OF THE ASSETS AT TAKEOVER?

ANSWERS 6 AND 7:

To get an indication of gross and net recovery on assets, we analyzed the actual and projected recovery on assets for 63 banks that failed in the first half of 1986 in our 1988 report.[2] (Prior to 1986, data were not available.) It should be noted that book value is not in itself a good indicator of asset value. The results are shown below.

Table 4.1: Average Estimated Recovery Rates as of March 31, 1988, for Banks Failing January through June 1986

Dollars in millions

	Total (63)	Purchase and assumption transactions (43)	Deposit payoffs and transfers (20)
Adjusted original book value of acquired assets[a]	$1,747	$1,245	$503
Actual			
Actual expenses (1/86 to 9/87)	$102	$74	$28
Actual collections (1/86 to 9/87)	600	338	262
Actual writeoffs	156	99	57
Actual gross recovery rate[b]	34.4%	27.2%	52.1%
Actual net recovery rate[b]	28.5	21.3	45.5
Actual writeoff rate[c]	8.9	7.9	11.4
Estimated			
Estimated gross cash collections	$450	$361	$90
Estimated future expenses[d]	103	89	14
Projected gross recovery rate[e]	25.8%	29.0%	17.9%
Projected net recovery rate	19.9	21.8	15.2
Combined recovery rate			
Combined actual gross and projected gross recovery			
Average	60.1%	56.2%	70.0%
Median	63.5	59.5	72.1
Combined actual net and projected net recovery			
Average	48.4%	43.1%	61.6%
Median	42.6	37.2	64.4

[a] Adjusted original book value of acquired assets includes the original book value, discovered assets, repurchased assets, and advances made to debtors to protect FDIC's interest in its assets.

[b] The actual gross recovery rate is calculated by dividing actual collections by the adjusted original book value of acquired assets. The actual net recovery rate is determined by using the same calculation but deducting actual expenses from actual collections.

[c] The actual writeoff rate is calculated by dividing the actual writeoffs by the adjusted original book value of acquired assets.

[d] Estimated future expenses are determined by multiplying the estimated gross cash collections by the ratio of actual expenses to actual collections using the liquidations' 15 to 21 months of historical data.

[e] The projected gross recovery rate is calculated by dividing the estimated gross cash collections by the adjusted original book value of acquired assets.

[f] The net projected recovery rate is determined by dividing the projected gross cash collections less the estimated future expenses by the adjusted original book value of acquired assets.

Notes: Numbers in parentheses indicate the number of liquidations in each category.

Adjusted original book value and estimated gross cash collections categories do not add up to the total because of rounding.

Source: Developed by GAO from data provided by FDIC using the Financial Information System and Estimated Cash Recovery Report Number 3, Timing of Estimated Cash Recoveries as of September 30, 1987.

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[2] Failed Banks: FDIC's Asset Liquidation Operations (GAO/GGD-88-132, Sept. 1988).

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QUESTION 8: COMPARE THE STRENGTHS AND WEAKNESSES OF FSLIC AND FDIC ASSISTED TRANSACTIONS. FOR EXAMPLE, HOW DOES THE "PUT" OPTION ARRANGEMENT FOR BAD ASSETS IN NCNB'S FDIC ASSISTANCE AGREEMENT COMPARE WITH THE CAPITAL LOSS COVERAGE AND YIELD MAINTENANCE USED BY THE FSLIC?

Answer 8:

As you are aware, during your March 14, 1989 hearing we raised many concerns about FSLIC's 1988 transactions to resolve insolvent institutions. However, we have not conducted a similar assessment of all FDIC assisted transactions. And, because of the short time in which we were requested to provide responses to your questions, we could not compare all, or a large number, of FDIC and FSLIC assisted transactions and, therefore are unable to compare the strengths and weaknesses of the two approaches. The following paragraphs briefly summarize FDIC's NCNB Texas transaction, as requested, and FSLIC's First Gibraltar transaction. The comparison is based on the latest information available at the time of our analysis and may not be definitive. First Gibraltar was selected because the acquired thrifts are in Texas and the transaction was the largest of FSLIC's 1988 assisted mergers in Texas. The NCNB Texas transaction is somewhat different in that the failed predecessor bank - First Republic - was closed and made an FDIC bridge bank some four months prior to consummation of the assistance agreement with to NCNB. And, First Republic itself had received assistance prior to failure; some of this debt was assumed by the bridge bank.

NCNB TEXAS

Summary:

On July 29, 1988, FDIC was named receiver of the failed First RepublicBank of Texas, which as a holding company owned some 40 banks. FDIC established a bridge bank. On November 22, 1988, FDIC consummated an agreement with NCNB Corporation, NCNB Texas Corporation, NCNB Texas Bancorporation, Inc., and NCNB Texas National Bank. Under this agreement, NCNB Texas National Bank, the bridge bank's new name, received a capital infusion by NCNB which resulted in a 20 percent ownership interest and option to purchase the 80 percent equity position held by FDIC. NCNB Texas was to manage and liquidate a "pool" of assets under the agreement. "Pool" assets as of the consummation date were valued at $6 billion; other assets of NCNB Texas carried at adjusted book value were $19 billion.

FDIC agreed to pay NCNB Texas, the bridge bank, the amount of negative equity which existed at the consummation date (November 22, 1988). The negative equity at the consummation date was equal to the actual book equity at that date, adjusted for "mark to market" valuations. The resultant amount was ($1.132 billion) and was paid by FDIC through the assumption of $1.0 billion in First Republic debt to the Federal Reserve, which bears interest at 8.5 percent, and the forgiveness of $132 million of a $300 million outstanding revolving credit agreement owed by the bridge bank to FDIC. There was an adjustment period (from November 22, 1988 through January 10, 1989) during which FDIC could adjust any of the "mark to market" valuations used to calculate the negative net worth, if NCNB concurred with the adjustment. As a result of the adjustment period, NCNB paid FDIC $267 million in cash.

Open bank assistance notes receivable owed to FDIC by First RepublicBank totalling $1.051 billion were not assumed by the bridge bank and became claims against the First Republic receivership. FDIC as receiver considered them not collectible, and FDIC has fully reserved (expensed) for the amount.

1. Equity Position

FDIC provided $840 million to NCNB Texas for an 80 percent interest in the bank, and NCNB infused $210 million for a 20 percent interest. FDIC purchased non-voting common stock that is convertible to voting common stock when FDIC sells it. As a result of its interest, FDIC will receive 80 percent of the benefit of the net income of the bank. NCNB purchased 100 percent of the voting stock. These two infusions brought the bank's capital to 6 percent of total assets at the consummation date. NCNB has an exclusive option to purchase FDIC-owned stock for five years after the consummation date. For an additional three years NCNB has the right of first refusal. The repurchase price is to be 115 percent of the book value of the stock in the first year, 120 percent in the second year, and 125 percent after year two.

2. Asset Provisions

A separate asset "pool" was created that consists, generally, of nonperforming loans and other debt of these borrowers. The assets in this pool were valued at their "mark to market" valuation prior to being transferred to the pool. All loans put in this pool were agreed to by FDIC and NCNB. Further, for the first 12 months after consummation, NCNB has the right of unlimited puts to the pool; in the second year after consummation, it can put in assets valued at up to $750 million. FDIC may disagree to allowing specific puts; any disputes are arbitrated by the Office of the Comptroller of the Currency.

The separate asset pool will be carried on NCNB Texas books until the earlier of NCNB's acquiring a majority interest in the bank (i.e., at least 51 percent) or FDIC's electing to purchase the pool at its book value (the mark-to-market value at the date they were put into the pool).

FDIC is required to pay NCNB the net loss (i.e. the difference between the bridge bank's book value and the estimated net realizable value at the date put to the pool) of any individual asset put, at the date it is put, to the pool or the loss from book value of any asset sold from the pool. Further, FDIC reimburses NCNB for all costs associated with managing the separate asset pool and provides a "cost to carry" factor to ensure that NCNB Texas earns a yield on pool assets equal to its average cost of funds.

3. Exposure

FDIC's principal areas of future exposure in this agreement relate to (1) the lack of certainty that NCNB will buy a majority interest in the bank and (2) the ultimate value of the pool of assets. If NCNB elects not to buy a majority interest in the bank, FDIC will be forced to find and fund a new buyer for the bank. The exposure regarding pool assets is threefold. First if the market value of the pool assets continues to deteriorate, FDIC may not recover current estimated value. Second, the reimbursements to NCNB Texas to manage and carry the pool assets may be higher and last longer than expected. Finally, the costs associated with future puts may be higher than estimated; this future put exposure ends on December 31, 1990. FDIC officials say there are controls in place over the management and liquidation of pool assets.

FIRST GIBRALTAR

FSLIC sold 5 Texas thrifts[3] on December 27, 1988 in a transaction variously known as the Utley-Ford, MacAndrews-Forbes, Perelman, and First Texas transaction. The new thrift, formed from the failed thrifts, is known as First Gibraltar. FSLIC provided an initial promissory note equal to the negative net worth of the acquired thrifts, capital loss coverage and a yield guarantee on covered assets, and a mark to market adjustment on noncovered assets. Certain expenses are also reimbursed.

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[3] First Texas, Gibraltar, Killeen, Montfort, and Home.

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1. Negative Net Worth

The amount of negative net worth of the acquired thrifts was estimated to be $866 million in cash terms. FSLIC provided First Gibraltar with an initial 10-year promissory note to be adjusted as needed based on an initial audit. The present value cost to FSLIC of the principal and interest was estimated to be about $800 million. The note carried a variable interest rate of the average Texas Cost of Funds plus 50 basis points.

2. Equity Position

The acquirer infused $160 million in cash, in return for 100 percent of the common stock. Another $155 million consists of subordinated debentures.

FSLIC received warrants entitling it to acquire, for a minimal fee, 20 percent of First Gibraltar's common stock. The warrants may be exercised at any time for 15 years.

3. Asset Provisions

FSLIC designated certain classes of assets, for example, real estate owned, and guaranteed their book value. FSLIC is committed to paying "capital loss coverage" on $10.2 billion in assets according to a FSLIC official. FSLIC will make up any difference between book value and sale price when such assets are sold for less than book value, or, will pay the estimated difference if an asset is not sold at the close of the agreement period. The book value is the value on the books of the failed thrifts plus any reserves for these assets. Other assets were marked to market as of the date of the transaction, resulting in $193 million mark-down, which is to be paid to First Gibraltar over the ten-year period.

FSLIC estimates that the present value cost of the capital loss coverage is $1.35 billion and that the cash cost is $2.74 billion.

Until certain classes of assets are liquidated, FSLIC guarantees a yield based on the average Texas Cost of Funds plus a premium. The period is up to 10 years. The premium ranges from 225 basis points in year 1 to 150 in year 10. The estimated present value cost of this yield subsidy is $1.36 billion, and the cash cost is $1.81 billion.

4. Exposure

Losses on asset sales, reimbursed expenses, and the guaranteed rate base (the average Texas Cost of Funds) for the yield subsidy and notes may all be higher than estimated. We have concerns that there is a lack of incentives in the 1988 FSLIC transactions to maximize recovery on the covered assets. With respect to impact on the local cost of funds, we note that NCNB Texas is guaranteed a return equal to its own cost of funds, whereas First Gibraltar is guaranteed a rate based on the average Texas cost of funds. FSLIC is setting up monitoring and control programs, but the task of conducting such programs for all the 1988 transactions is enormous.

Whereas, FDIC may buy back NCNB pool assets at book value at any time, FSLIC is limited as to the amount of covered assets it may buy back annually from First Gibraltar, although such a limitation is not typical in FSLIC assistance agreements.

The possibility that First Gibraltar will not succeed and may in the future require additional assistance or may fail cannot be ruled out.

QUESTION 9: HOW MUCH OF THE CAPITAL CONTRIBUTION BY NCNB CAN BE DIRECTLY OR INDIRECTLY BORROWED FROM THE FDIC? AT WHAT RATE? FOR HOW LONG? IS THERE AN IMPLICIT SUBSIDY COMPARED TO THE COST OF PRIVATE CAPITAL?

ANSWER 9:

None. The agreement requires that all capital contributions made by NCNB, including the repurchase of FDIC's capital contribution ($840 million) at a premium, be done without any assistance from FDIC. The initial $210 million infused by NCNB to purchase 100 percent of the voting common stock of the bridge bank was all private capital.

Although the agreement requires NCNB to make capital contributions without FDIC assistance, NCNB is allowed to purchase certain FDIC ownership interest by issuing a promissory note. Specifically, the agreement requires NCNB to increase its ownership interest to 100 percent within 1 year of its acquiring at least, 75 percent (6 million shares) of FDIC's ownership interest. The agreement allows NCNB to pay the purchase price of the remaining 2 million shares with a promissory note having a final maturity three years from the option closing date. This note bears interest, to be paid semi-annually, at a rate per annum equal to the weekly average yield on actively traded U.S. Treasury Securities adjusted to a constant maturity of 3 years plus 6 basis points.

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QUESTION 10: WHAT PERCENTAGE OF THE TAX BENEFITS DOES THE FDIC RECAPTURE IN THE NCNB TRANSACTIONS IF ONE EXCLUDES THE INITIAL FDIC "HOLE FILLING," WHICH WOULD NOT NORMALLY BE TAXABLE IN A NON-GOVERNMENT TRANSACTION?

ANSWER 10:

FDIC has informed us that it expects to obtain, through its ownership position, at least 80 percent of the value of the tax benefits during the period in which it holds 80 percent of the common stock. To the extent NCNB exercises its option to purchase FDIC-held stock, FDIC obtains, through the exercise price, a multiple of the benefits realizable to that date. If a favorable ruling is obtained from the Internal Revenue Service regarding section 597(a) of the Internal Revenue Code of 1986 as amended by the Technical Corrections and Miscellaneous Revenue Act of 1988, FDIC will be paid by NCNB Texas Bancorporation, concurrently with the exercise of its option to purchase all remaining FDIC common stock, $63 million. FDIC estimated this to be the present value of the benefits to be received as a result of that ruling.

QUESTION 11: HOW DOES THE ESTIMATE OF APPROXIMATELY $4-$5 BILLION IN LOSSES ON THE BAD ASSETS IN THE NCNB TRANSACTION COMPARE TO THE FDIC'S COST ESTIMATE OF APPROXIMATELY $1-$2 BILLION?

ANSWER 11:

We are not certain of the source for the estimate of $4 - $5 billion in losses on the bad assets or the FDIC cost estimate of approximately $1 - $2 billion. However, as of June 13, 1988, FDIC's Division of Liquidation prepared an "Asset Review Loss Estimate" of the two primary banks (Dallas and Houston) of the failed First Republic Bank of Dallas, Texas. This resulted in an estimated loss of $5.3 billion. This estimate included approximately $1.3 billion in estimated costs for overhead expenses and lost opportunity costs. Further, this estimated loss was based on gross asset values giving no effect to existing loss reserves provided by the bank on these assets of approximately $3.1 billion. This Asset Review Loss Estimate along with many other analyses done by FDIC on failed banks is used to determine the least costly approach to resolving the problem.

FDIC in its financial statements for 1988 provided (expensed) $3.0 billion as its net estimated cost on the NCNB/First Republic Bank transaction. This FDIC cost estimate was composed as

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follows, based on the "material" terms of the assistance agreements:

Account	Amount (in billions)
-- Reserve for loss on assistance notes receivable due from failed bank prior to failure.	$1.051
-- Excess of estimated repurchase price of stock over initial investment ($840 million)	(.328)[a]
-- Funding of negative equity after "mark to market" of all assets.	.865
-- Estimated loss on future puts (total projected book value of estimated puts was $1.773 billion)	.567
-- Estimated cost of operation and cost to carry on separate asset pool net of income from pool	.845[a]
	3.000

[a] These amounts were adjusted to their present value using a 8.5 percent discount rate and a 5 year life.

GAO's Response to Questions received from Senator Riegle subsequent to GAO's March 14, 1989, testimony before the Senate Banking Committee on problems facing the Savings and Loan Industry

QUESTION 1:

Please expand on your testimony to explain which tax benefits are intended to be used only by the thrift and which can be used in other parts of the organization to which the thrift belongs. Explain how those benefits designed to benefit the thrift can also benefit other parts of the holding company.

ANSWER 1:

Two sets of special rules are applicable to FSLIC's resolution of troubled thrifts. All tax benefits from both sets of special rules are usable at the thrift level. All but one of these benefit items, the pre-agreement net operating losses, can also be used at a holding company level in the event that the thrift is part of a group which is covered by consolidated (single) return filing.

The first set of special rules excludes FSLIC assistance payments from taxable income and from inclusion in the tax basis (cost) of assets.[1] This set of rules applies to either the thrift or holding company. The second set of rules allows the merger of the troubled thrift and the acquirer to qualify as a tax free reorganization.[2] Tax free reorganization status preserves the net operating losses (NOLs) accumulated before the merger so that they can be used to offset future thrift income. These NOL's, generally, cannot be used to offset holding company income. The tax free reorganization also preserves the basis (cost) of assets used by the troubled thrift. This basis or cost value of the asset is usually higher than the asset's fair market value. A loss is generated when the asset is sold, referred to as a built-in loss. It can be deducted against thrift income and, pursuant to a set of exceptions, can generally be deducted against holding company income. The exemptions are ordinary tax rules (i.e. not solely applicable to thrifts).

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[1] 26 U.S.C. 597 (a) and (b).

[2] 26 U.S.C. 368 (a)(3)(D) and 382 (1)(5)(F).

QUESTION 2:

The Administration's proposal offers little guidance on the best ways to handle liquidations and the assets that the government acquires in the resolution process. Congress may want, however, to offer some guidance and express its intent regarding some principles to be followed and some pitfalls to be avoided. Please express GAO's thoughts on these issues.

ANSWER 2:

The total amount of assets held by FSLIC, by 1988-assisted thrifts, and by insolvent thrifts awaiting resolution is staggering. Other than a general requirement that any resolution be no more costly than liquidation (including a payoff of depositors), current law gives FSLIC broad discretion to resolve failed institutions. In the case of liquidation, 12 U.S.C. 1729(b)(1)(A) authorizes FSLIC to liquidate an institution's assets in an orderly manner. The law does not place any other restriction on how FSLIC proceeds with the liquidation. Congress may wish to consider providing guidance to the federal entity given responsibility for handling assets on a number of issues, including:

-- To what extent should resolution strategies that quickly return assets to the private sector be emphasized over strategies under which the responsible federal entity acquires the assets for liquidation?

-- If assets are acquired by the federal entity, should the primary goal be (1) to quickly return the assets to the private sector, (2) to maximize potential net revenues, (3) to minimize the potential adverse effects on local economic environments, or (4) some combination of these goals?

-- If assets are to be quickly returned to the private sector, key questions are (1) to what extent should sales of assets be limited to cash, non-recourse transactions; (2) to what extent should the federal entity seek to retain an equity interest in assets it expects to appreciate; (3) to what extent should it accepts risks as part of the sale transactions; and (4) should all parties, even those with previous interests in the assets, be permitted to buy them?

-- To what extent should the responsible federal entity hire permanent and/or temporary employees to obtain skills to manage and liquidate assets rather than contract with private-sector firms for this work?

-- If contracts with private-sector firms are used, what kind of provisions should be included to insure the proper incentives?

-- Are the monitoring needs for the 1988 FSLIC-assisted transactions so extensive and FSLIC's continuing exposure to risk so high that the responsible federal entity should take advantage of agreement provisions to buy back the guaranteed assets?

Who should liquidate assets?

Both FSLIC and FDIC have, at various times and under varying conditions, acquired for liquidation all, some, and almost none of the assets when resolving failed depository institutions. To the extent that the insurer does not acquire the assets, they are placed in existing or newly created depository institutions as partial compensation for the liabilities of the failed entity that such an institution accepts. FDIC had traditionally taken over the poor quality and charged-off assets of failed banks and sold the remaining healthy part of the bank. But, FDIC more recently, due to the dramatic increase in bank failures, has structured sales when possible so that substantially all the failed banks' assets are acquired by the purchaser.

In 1988, FSLIC relied extensively on a technique which passed most of the assets of the failed thrifts to their purchasers but guaranteed their value and yield for up to 10 years. In such an arrangement, the assisted thrift is responsible for asset liquidation, but FSLIC remains exposed to (1) further asset depreciation and (2) the possibility that net recoveries will be less than would have been the case had the assets been completely under FSLIC control or private sector ownership.

What should the federal entity's primary liquidation goal be?

If the goal is to return assets as quickly as possible to the private sector, they might be sold "as is," so that economic decisions on further asset development could be made by the marketplace in a competitive environment. If, on the other hand, the goal is to maximize return and the insurer is confident economic recovery (and thus demand) in an area will be forthcoming, it might develop some assets further and hold others off the market for several years.

Concerns over "dumping" assets arise from a belief that the responsible federal entity will sell assets (properties) at prices and in timeframes that will cause other properties to decrease in value. While each of the federal deposit insurers maintains that it does not "dump" assets, it appears that they define "dumping" differently. FHLBB has defined "dumping" as "the sale of any asset or number of assets that causes a decline in market value of comparable assets in the marketplace." The FDIC position was recently expressed by its chairman as selling at less than appraised value.

What risks should the federal entity retain?

Should the federal entity provide financing to the purchaser of an asset? It may be that this is the only way the asking price can be obtained. Should the federal entity hold an interest in the asset to benefit from perceived upside potential?

In its 1988 assisted-mergers, FSLIC made extensive use of future commitments rather than paying cash when selling institutions whose liabilities far exceeded their assets. However, these asset and yield guarantees are open-ended, difficult to cost, and require extensive monitoring to be sure full value is obtained and expenses are not excessive. FSLIC remains exposed to the risk that the assets will, for reasons external to their management, decline further in value. By using cash and providing for no, or minimal, recourse, uncertainties regarding the cost of the transactions can be reduced or eliminated. But the insurer must have a good knowledge of the failed entity. And, the insurer does not maintain the ability to share in gains if the asset does appreciate.

While not a risk, another question regarding asset sales is whether any and all interested parties be permitted to purchase assets acquired by the responsible federal entity or should parties that previously had an interest in the assets prior to the government's acquisition of the asset be disqualified on the theory that they contributed to the problem and should not be permitted to profit from it? Such "interested" parties may submit the highest offer for a property due to first-hand knowledge about its value. Both the insurers are presently grappling with this question.

Should the federal entity rely on its own staff or on contracting?

Critical to this decision is the extent to which any applicable federal ceilings on the number of employees or their pay would be viewed as an obstacle to obtaining resources needed for getting the best return on assets. As you know, FHLBB created the Federal Asset Disposition Association (FADA) at least in part because it felt that it could not, under federal ceilings, appropriately manage and liquidate assets. FDIC, in contrast, manages assets primarily in-house with a large pool of temporary federal employees. But, it has recently been reducing the assets it acquires by using more whole-bank sales. An official has noted, however, that FDIC, if given responsibility for thrift assets, will consider increased contracting, particularly in light of the large amount of properties.

What incentives should be used in contracts?

Our work for this committee on the need for FADA, (Failed

Thrifts: No Compelling Evidence of a Need for the Federal Asset Disposition Association, GAO/GGD-89-26, Dec. 1988) and on the 1988 FSLIC-assisted transactions has shown that the incentives in any compensation arrangement need to be very carefully designed to fully protect the insurer's interests. Certain provisions can encourage managers to sell assets less expeditiously than appropriate, to sell them for less than the maximum amount, and to minimize maintenance of assets. Other provisions can encourage managers to spend more than needed in the process.

At the March 14 hearing, we were asked about the incentives in contracts that thrifts resulting from the 1988 FSLIC transactions have with asset managers. We asked FSLIC for copies of these contracts, but had not received any as of April 5, 1989. We were given incomplete information on March 28, 1989, that indicates that some of the acquirers have contracted for asset plan preparation, and some have contracted for asset management services; they plan to apply for at least partial reimbursement.

What should be done about guaranteed assets in the thrifts resulting from the 1988 FSLIC transactions?

We asked FSLIC for information on guaranteed assets to help assess the monitoring demands of the transactions. Incomplete data provided on March 10, 1989, shows that there are almost 9,000 guaranteed assets at the Texas and Oklahoma Southwest Plan thrifts for which such data was provided that are considered to be major or significant assets. Such assets have extensive reporting requirements due to the magnitude of either the book values assigned to them or the expected losses to be incurred when they are liquidated. (The reporting thresholds vary greatly, but start, for example, with asset book values of $1 million.) Business plans, collection plans, or property plans (depending on the type of asset) as well as budget and asset summaries are required. There are thousands of other assets in these thrifts as well, with other reporting requirements. Guaranteed assets of thrifts in the 3 non Southwest Plan transactions we reviewed, for which data were provided, totalled about 2,000 and were valued at about $1.9 billion.

We have testified as to our belief that there is a lack of incentives in the assistance agreements to insure that guaranteed assets are liquidated in the least costly manner to FSLIC and the government. Because of this situation, the oversight of the agreements becomes of paramount importance. We are concerned that FSLIC does not presently have the resources to implement such oversight effectively. Whatever entity is given this responsibility will find it a formidable challenge.

Provisions in many transaction agreements, however, allow FSLIC to purchase or require the sale of guaranteed assets. They are important because once a guaranteed asset is sold and the amount due from FSLIC is paid, capital loss coverage, yield maintenance, and cost reimbursement provisions are no longer in effect. If all the guaranteed assets are sold, interest and principal payments on the negative net worth notes, other notes, and reimbursed expenses (such as indemnifications) would be the only continuing financial assistance commitment.

QUESTION 3:

Please review the proposal of former Deputy Treasury Secretary, Tim McNamar, to handle troubled assets.

ANSWER 3:

The McNamar proposal is meant to address the following issue: "In already depressed real estate markets, how can the Resolution Trust Corporation (RTC) be used to minimize market depressing 'fire sales' of troubled real estate owned (REO) by the Savings Association Insurance Fund (SAIF) receiverships while maximizing SAIF sales for cash to promote timely liquidation of insolvent depository institutions ?." It outlines a method by which states and municipalities in conjunction with the RTC would form Real Estate Liquidation Trusts. When we met with Mr. McNamar, he emphasized that the proposal he provided was an initial, partially developed, draft concept paper and that many unresolved issues needed to be addressed.

Under the proposal, the Trusts would bid for and purchase real estate from the RTC, receiverships, and other institutions in arms-length transactions. The Trusts would contract with private real estate management companies for the completion, management and leasing of the real estate properties. The properties would be sold over the course of 10 or 15 years as warranted by individual circumstances. The source of financing for the acquisition of property would be the proceeds of tax exempt zero coupon municipal bonds with a maturity of 10 to 15 years issued by the individual trusts. The proceeds from operating and disposing of the real estate property would be used to redeem the bonds at maturity. RTC and the respective state or local governments sponsoring the trusts would purchase zero coupon Treasury bonds on an equal basis with a maturity identical to the tax exempt underwriting. The face value of the Treasury bonds would be equivalent to 30% to 40% or more of the face value of the tax exempt financing. In the event that there is a shortfall in the funds available to redeem the tax exempt financing at maturity, the escrowed funds would be available to make it up.

While the proposal has merit because it would tap a new source of funds to help deal with the savings and loan crisis, we have several concerns that we believe need to be addressed.

-- The proposal's premise is that the disposing federal agency would proceed to liquidate real estate without regard to the impact on market conditions and consequently end up depressing real estate prices in some localities. This premise is unproven and debatable.

-- Although the proposal's intent is to keep real estate assets off the market in depressed areas, there are no incentives built into the trust arrangements to do this. Furthermore, the trusts may select the assets they wish to buy and could thus, be most interested in the type of assets that would also appeal to private sector purchasers, and therefore could be disposed of quickly with little impact on market prices.

-- The proposal does not take into account the costs of operating, managing, and selling assets. These costs must be included in any assessment of the ultimate viability of the proposal.

-- Under this proposal, despite the sale of assets, the federal government remains obligated for a portion of the principal and interest due on the bonds issued by the trusts. Despite the federal exposure, there are few provisions for federal control or oversight.

-- Finally, the market place is not familiar with the bonds to be underwritten. If, because of this, terms are very stringent or yields are quite high, the economics of the proposal might become too costly.

QUESTION 4:

Please re-estimate the size of the S&L problem when the FDIC has completed its audit of failed thrifts.

ANSWER 4:

Because FDIC has not completed its work in institutions comprising FSLIC's caseload of insolvent thrifts, we cannot respond to this question at this time.

QUESTION 5:

What guidelines do you recommend to govern the salaries paid to executives of thrifts that are being resuscitated with government assistance?

ANSWER 5:

Our past involvement in the federal financial rescues of the Lockheed, Chrysler, Conrail and New York City situations--particularly the Chrysler situation--provides some guidance regarding executive pay levels and the degree of management autonomy in federally assisted organizations. It seems to us that where federal aid is used to either keep a failing firm alive or to create a new firm that is viable only because of the aid, the government should reserve the right to set executive pay and constrain management decisionmaking autonomy in ways deemed appropriate to protect the federal interest. While cuts in pay or limitations on salary or decisionmaking may not significantly affect the finances of the assisted firm, they are very important symbolic steps.

QUESTION 6:

Do you observe any patterns of favoritism in the deals made last year. I am particularly interested in cases where former insiders from the Federal Home Loan Bank System purchased failed thrifts or acted in some capacity to help arrange the deals. In how many of last year's deals were former senior Bank Board officials involved? Did they benefit from inside information in those deals?

ANSWER 6:

GAO is actively investigating allegations of favoritism and possible release of inside information in connection with the sale of failed thrifts. GAO does not know in how many of last year's deals former senior bank officials were involved. Our investigation into these matters is continuing.

QUESTION 7:

Please suggest standards and offer guidelines for the maintenance of adequate records regarding the deals.

ANSWER 7:

Because of the difficulties we had in developing independent judgements on the quality of the decisions FHLBB made in the selection of acquirers for failed thrifts, we believe the Resolution Trust Corporation should be required to maintain documentation in a central location sufficient to develop audit trails supporting the decision process. This documentation, at a minimum, should include a detailed chronology of the entire process, starting with the first time a failed thrift is marketed, all proposal calculations, cost analyses, and the rationale for the estimated costs, full explanations for any deviance from normal procedures, written records of all discussions and/or meetings with potential acquirers, written records of all analyses of proposals including the criteria and evidence supporting the decisions made, and written transcripts of all Board meetings where a transaction is discussed and an index of such meetings.

Accordingly, on March 24, 1989, we provided the Committee with a proposed amendment concerning the solicitation and selection process for assisted acquisitions. The section of the amendment dealing with documentation requirements follows.

> "(2) The Corporation shall document decisions made in the solicitation and selection process and the reasons for the decisions. The Corporation shall maintain this documentation as well as any other documentation relating to the solicitation and selection process in its offices."

Difficulties Encountered in Reviewing Decisions on Deals

At your March 14, 1989, hearing, in which we discussed our concerns about FHLBB's 1988 transactions involving insolvent thrifts, you asked that we continue our work in this area, focusing on the adequacy of the documentation provided by the Bank Board to support decisions on selecting an acquirer from among the eligible bidders. We had continually sought documentation for these transactions while conducting our analysis. But, as we said at the hearing, there was not sufficient documentation for us to determine how decisions were made in selecting acquirers, and furthermore, we were not certain that we had all relevant documentation available at the Bank Board. As a result of your request, we again asked the Bank Board for all documentation supporting the selection of the final acquirers for the 12 transactions we had been reviewing. The

Bank Board subsequently provided us with additional documentation, which we reviewed along with the documentation previously provided.

Our review of all this material showed a general lack of documentation sufficient for us to develop audit trails that would enable us to independently judge the quality of the decisions made in the selection process. Furthermore, the documents revealed inconsistencies that were not always fully explained among various transactions and raised several still unanswered questions concerning the actions taken.

As pointed out earlier in this hearing, FHLBB is generally not required to maintain the type of documentation we normally find in procurement transactions. Most actions were at least partially supported by documentation, but missing or incomplete documentation was evident in all 12 transactions. Cost analyses to support cost related decisions were not always provided. For example, proposals to acquire thrifts were rejected because they did not meet FSLIC's "strike" price or because they exceeded the estimated liquidation cost, but we were not provided the cost analyses associated with those decisions. One potential acquirer was rejected because the cost of its proposal was more than the cost of other proposals, but a cost analysis was not done for that proposal. Overall, FSLIC used different cost analysis methodologies and methodologies used may not have included all costs of the transactions. Since we were not provided the actual supporting analyses, we could not be sure.

Other types of analyses and the criteria used to reject proposals were also not provided. For example, proposals were rejected because they did not conform to the bid solicitation instructions. However, documentation did not always specify what all the variances were or the criteria used to evaluate them. In one December transaction, the high cost bidder was selected for reasons other than cost. A primary reason given was the ability of the winning bidder to close the deal more quickly than the other bidders. However, the documentation showed this conclusion and the other reasons were based on subjective judgements that were not fully supported. Reasons given for rejecting proposals in other transactions were that they did not provide as high a likelihood of consolidation or as high a level of competition as other bids. However, no documentation was provided showing the basis for these decisions. In another transaction, the rationale for the selection decision was not explained. Documentation for this transaction said the Board considered the qualified proposals' "respective costs and other advantages and disadvantages, and the selection . . . is in all respects in accordance with the standards applied by the FSLIC and the Board in the resolution of supervisory cases." However, the summaries of cost analyses provided did not follow the normal FSLIC methodology and we could not determine what the other advantages and disadvantages were.

The documentation provided during the last 2 weeks of March also raised new questions, especially concerning inconsistencies among transactions. For example, one document said that a top FSLIC official directed that a certain investor be allowed to bid on a thrift late in the process even though that investor had not been involved before and the bidding process was well underway. Related documents suggest that this official would not allow the deal to go ahead with an acquirer recommended by the district bank in order to consider an anticipated bid from the new investor but do not explain how the new bidder became involved or state exactly what the official said. Another document said the reason the recommended acquirer should be rejected was because its proposal was within 10 percent of the cost of liquidation, but we noted other transactions were approved in which the cost was within 10 percent of liquidation cost. In another transaction, a bidder was considered eligible but was not selected partially because its "new" capital infusion was less than another bidder's capital infusion. ("New" capital was considered in this transaction as coming from outside the thrift industry.) The losing bidder was a thrift and its existing capital was not considered in the comparison. In another transaction, a thrift was selected even though it proposed no "new" capital and had limited existing capital.

We are still not sure we have all documents concerning the selection process and it is not likely that we ever can be. We asked for the sources of data, for example, used in the cost analyses of some proposals, but the documentation provided did not fully support the results of the analyses. We were told some data were lost after the analyses were completed and they could not provide us with written documentation for all the data sources. One of the documents we were given said that some files on the matters we requested had been thrown away. FSLIC officials also told us documents concerning the transactions are scattered all over the agency, and that no one knew where all of them were. In fact, as of March 31, 1989, we continued to receive documents from FHLBB on a sporadic basis.

An important part of the process is the Bank Board meetings where the transactions are discussed and approved. These meetings are taped but the tapes--especially later in 1988--have not been transcribed. Bank Board officials told us several hours of these tapes exist for the period during which these transactions were taking place. A number of tapes were provided to us late in March 1989. Time did not allow us to listen to all the tapes. Nevertheless, while the tapes reveal the discussions that took place, they do not provide the documented analyses behind the decisions.

The Bank Board's Office of Inspector General (IG) is reviewing the Southwest Plan's selection and negotiation process. We discussed this review with IG officials, who told us they had not been able to develop an audit trail concerning the process that answered all their questions.

QUESTION 8:

How does GAO believe that the S&L rescue should be financed? Please suggest alternative financing options.

ANSWER 8:

Our views on this matter have been discussed with the Committee separately.

QUESTION 9:

The Administration's plan authorizes the Resolution Funding Corporation to review the deals made last year. It is not clear whether the amount budgeted for the old cases includes funding for any changes that may be recommended. Moreover, GAO's analysis suggests that the deals may be more expensive than the plan projects. What adjustments to the financing plan do you recommend in light of the costs you project for the old cases?

ANSWER 9:

We cannot answer this question at this time. We indicated in our testimony that once the financial audits of the institutions comprising the various transactions are completed, the costs may well be higher than those that FSLIC has estimated. We indicated that there were preliminary results from one audit that the value of assets was considerably less than the market value FSLIC had estimated. Since these audits are not completed, we cannot recommend adjustments to the financing plan to reflect mark downs in the value of financial assets in the various 1988 transactions.

QUESTION 10:

The FHLBanks examine and supervise thrifts in their region. Chairmen and CEOs from prominent local thrifts sit on the board of directors of their FHLBank. This situation presents a potential conflict of interest. An article by Kathleen Day in the Washington Post on March 16 cites 4 instances where this conflict was abused at the Dallas district bank.

Do you know of any similar conflict abuses that have occurred at the FHLBanks?

Do you believe that Congress needs to take responsibility for examination and supervision away from the district banks?

ANSWER 10:

We recognize the potential conflict inherent in the current organizational placement of thrift supervisors and examiners. We have testified several times on this issue and have recommended that the responsibility for supervision and examination as well as that for providing deposit insurance be removed from the current Federal Home Loan Bank system. While we do not have first hand knowledge of other abuses similar to those mentioned in the Washington Post article, GAO's March 22, 1989 testimony (see pages 36, 37 and 38) which we have enclosed discusses our rationale for this recommendation in greater detail.

QUESTION 11:

In his testimony before the House on March 10, Mr. Wolf said that "the FHLBanks can reasonably be expected to provide the funds they are being asked to provide to defease principal on the bonds and to help pay interest costs.... Using $300 million a year to pay a portion of the interest on the bonds should not significantly hurt the FHLBanks, nor should it reduce the amount of dividends paid annually to S&Ls.

Witnesses before the Senate Banking Committee on March 17 expressed a contrary opinion. The fear was expressed that the thrift industry will shrink because of consolidation and a difficulty in meeting capital requirements. In this situation, the amount and profitability of FHLBank advances might decrease. Then, a $300 million annual charge would become an increasing burden on the FHLBanks--one which might cut into the dividends S&Ls receive.

What is the basis of GAO's conclusion? What is your reaction to the March 17 testimony?

ANSWER 11:

Our conclusion regarding the feasibility of having the FHLBanks provide annual spending in the $300 million range is based on two factors. First, at the close of calendar year 1987, the FHLBanks' combined retained earnings amounted to about $2.5 billion. While most of this was pledged to support FICO bonds, it now appears a significant portion of this will not be needed because of lower than anticipated costs of defeasing the FICO bonds. Second, the FHLBanks combined annual income has averaged almost $1.3 billion for the years 1985 through 1987. During this time period, on average, the FHLBanks paid cash dividends of $518 million, and stock dividends of $402 million. This suggests that a $300 million annual charge would not significantly harm the FHLBank system's operations or ability to pay dividends.

We agree that there is always a possibility that future events could create circumstances affecting the FHLBanks' profitability and their ability to pay dividends to S&Ls. As stated in our recent report Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GAO/GGD-89-47), decisions about who should contribute to funding the thrift solution depend upon ability to pay and upon judgments about what is fair. As stated above, our view is that the FHLBank's current financial condition would permit the payments envisioned in the proposal. Should that condition change adversely in the future, the FHLBank system could seek redress from the Congress at that time.

QUESTION 12:

The Administration's proposal would prohibit thrift institutions from growing after June 1, 1991 unless they meet bank-type capital standards.

(a) Will the requirement cause many marginally healthy thrift institutions to fail?

(b) Is the requirement unduly stringent?

(c) In the long run, are the losses to the deposit insurance fund likely to be higher -- or lower -- under the Administration's proposal than they would be if institutions had more time to meet the higher capital standards (e.g., if an institution that could show that it was profitable and that its capital was increasing)?

ANSWER 12:

Many institutions face the prospect of having to raise their capital as a percentage of assets by 1991. Institutions can raise their capital percentages in a number of ways -- e.g., attracting new outside capital, increasing retained earnings, or reducing both assets and liabilities by corresponding amounts. We have no basis for knowing whether the requirement will cause many marginally healthy thrifts to fail because we cannot determine which method an institution will use, or how effective the method will be in meeting the new capital requirements.

We do not believe the requirement that institutions raise their capital percentages to meet the capital standards in the banking industry by 1991 is too restrictive. Our work has shown that forbearances and other methods to delay dealing with undercapitalized institutions to attempt to allow their conditions to improve have proven futile. Further, we have found that institutions have generally been unable to grow their way out of their problems. Therefore, to allow institutions that do not meet capital standards to grow will only exacerbate an existing problem.

Capital requirements have to be enforced if they are to be effective in influencing the risk-taking behavior of the owners and managers of depository institutions. We believe that it will be far less expensive to develop and implement a plan to rigorously deal with the marginally insolvent thrifts than to delay action, and allow their conditions to deteriorate. Thus, in the long-run, deposit insurance fund losses are likely to be lower under the Administration's proposal than they would be if institutions had more time to meet the higher capital requirements.

QUESTION 13:

Some thrift institutions that acquired failing institutions in the early 1980s have large amounts of goodwill on their books, which is currently being amortized over periods much longer than the 10-year maximum proposed by the Administration.

(a) These institutions contend that they performed a valuable public service by making the acquisitions in question, and that the goodwill they carry on their books was a primary incentive for the acquisitions -- a substitute for cash or other assistance. Do you agree?

(b) Would it be good public policy to permit such institutions to continue using the current amortization schedules, even if that resulted in permitting them to operate without any tangible equity capital?

(c) Is it really accurate to say that the goodwill in question here reflects the franchise value of the acquired institutions?

ANSWER 13:

A) Institutions that acquired failing thrifts in the early 1980s paid premiums (goodwill) for the thrifts because they judged it to be a good business decision. The goodwill they recorded as a result of these transactions reflected the value they believed the acquired thrift possessed as a going concern at the time of acquisition. Various bidders have different benefits and uses and thus different estimates of the firm's franchise value. The bidder's calculation will have been influenced by such factors as: size of the customer base, location, and ability to enter new markets (in some cases this represented a way to circumvent regulations and expand interstate), as well as different estimates of the market value of the assets.

The thrift whose bid incorporates the greatest amount of goodwill lowers the cost to FSLIC, and retains some advantages for the thrift. Thrifts with different estimates of goodwill are forced to support their bid with either a higher equity investment or greater assistance from FSLIC.

B) Over the course of the decade the economic value of the acquired thrift probably changed as has the value of other thrift assets. This change reflects the changing conditions in the financial services industry over the decade. When market values fall below book values and thrifts are not charged for the amount of risk they undertake, the incentive to undertake riskier activities increases. GAAP accounting rules require goodwill to be written off over a period of time that approximates the maturity of the acquired firm's long-term interest bearing assets. Changing the amortization schedule to better approximate the maturity of those acquired assets, or to reflect changes that have occurred in the charter values of thrifts, is appropriate to fairly present the institution's financial position.

C) Goodwill reflects the acquirer's estimate of the franchise value of the acquired institution at the time of acquisition.

QUESTION 14:

According to William J. Crawford, Savings and Loan Commissioner of California, "all but two publicly-traded savings and loan stock companies are trading below book value."

(a) Is S&L stock tending to trade below book value?

(b) If so, does that suggest that grandfathering current amortization schedules for goodwill could allow economically insolvent thrift institutions to remain open?

ANSWER 14:

We do not have information on the stock prices of publicly traded savings and loan institutions and could not readily obtain such information and make the comparison of stock prices to book values. Therefore, we are unable to answer this question.

QUESTION 15:

FSLIC contends that the thrift institutions resulting from FSLIC's December 1988 assisted acquisitions are adequately capitalized -- despite having a low ratio of capital to total assets -- because much of the institutions' assets consist of FSLIC notes and FSLIC-guaranteed assets, which are categorized as involving little or no credit risk. Do you agree? Has FSLIC succeeded in banishing the moral hazards of low capital, such as the incentives to take excessive risks?

ANSWER 15:

We believe "moral hazard" is still present to a substantial degree in FSLIC transactions, particularly the Southwest Plan transactions. Moral hazard is the incentive for the owners of the institution to impose risks on the insurance fund because they have little capital of their own at risk. We estimate that in 9 of 12 Southwest plan transactions we examined, investors can recover their capital investment through tax breaks alone within an average of 3 years. In other words, the potential real net loss to the investor, while not very large to begin with, declines quickly. Furthermore, the plan calls for the institutions to recover largely on the basis of internally-generated earnings, a major portion of which comes from FSLIC-guaranteed covered assets. If the institutions finance nearly all of their recovery using the earnings on these covered assets or by borrowing against these FSLIC-guaranteed assets, the owners will continue to have little of their own capital at risk.

The forbearance provisions included in the deals can also affect the owners' incentives to the extent they permit owners to make loans and investments not otherwise permitted for thrifts who do not meet regular capital standards. We recognize that in most, but not all, of the assisted transactions, the capital forbearances are linked to assets and liabilities of the acquired institutions. Depending on the investments assisted institutions are permitted to make, the insurance fund could continue to be exposed to considerable risk.

QUESTION 16:

Is it desirable for a regulator of federally insured depository institutions to act as an advocate for and promoter of those institutions?

ANSWER 16:

We do not believe it is desirable for a regulator of federally insured depository institutions to act as an advocate for and promoter of those institutions. Our work on the causes of S&L failures shows that the current structure of the Federal Home Loan Bank System is not conducive to effective oversight because there is a fundamental conflict created by the Federal Home Loan Bank Board's and district bank's roles of both promoting housing finance and regulating the thrift industry.

QUESTION 17:

Is it desirable for thrift regulators to have authority to prescribe accounting standards different from those of the Federal banking agencies?

ANSWER 17:

The GAO has consistently cautioned against the development and use of accounting standards which differ from generally accepted accounting principles (GAAP), and we would not favor permitting regulators of either thrifts or other financial institutions to prescribe accounting standards which are more lenient than GAAP. In our view, the past use of the more lenient standards, commonly known as regulatory accounting principles (RAP), has tended to mask the problems of the thrift industry.

The concern over the use of RAP as a substitute for GAAP essentially comes down to this: RAP rules have been generally more "lenient" than GAAP by permitting deferral of losses, capitalizing assets of questionable value, or front-end loading of income. As such, they have tended to disguise financial difficulties faced by regulated institutions, especially in the financial sector, thus depriving investors, depositors, regulators and the public of critical information they need to make decisions. In the long run, accounting practices that depart from GAAP also do not even serve the best interests of regulated institutions: the ability to "play games" with important financial information by hiding critical facts from regulators and the public merely postpones the inevitable day of reckoning.

We recognize regulators may have a need for more information than that disclosed in GAAP financial statements. We believe regulators should clearly have the authority, and in fact have an obligation to obtain any such information they deem necessary. We believe any requirements for such information should be viewed as being in addition to, rather than in lieu of, the requirements of GAAP.

In October 1987, more than two dozen prominent experts from government regulatory agencies, the General Accounting Office, and the private sector met in Washington, DC, to discuss growing concerns over legislatively-mandated regulatory accounting principles (RAP). These proceedings have been compiled in a report entitled Proceedings of the October 8, 1987 Roundtable Discussion on Generally Accepted Accounting Principles and Regulatory Accounting Practices, which we have enclosed for your information.

Positions on the
Financial Institutions Reform, Recovery and Enforcement Act

Endorsed by

The Federal Home Loan Banks

March 20, 1989

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March 20, 1989

The Federal Home Loan Banks--What They Are and What They Do

The twelve regional Federal Home Loan Banks (the "Banks") were established in 1932 to promote home ownership by assuring the availability of affordable mortgage loan financing. They do this principally by issuing debt obligations in the nation's capital markets and then lending the proceeds to qualified thrifts, which in turn make mortgage loans to the families that need them.

The Banks are located in Boston, New York, Atlanta, Pittsburgh, Cincinnati, Indianapolis, Chicago, Des Moines, Topeka, Dallas, San Francisco and Seattle and are owned by member institutions in their designated geographic areas. Appendix 1 shows Bank districts by state.

Funds for use to provide home mortgage financing are made available to thrift institutions through loans ("advances") made to such institutions by the Banks which raise their funds through the issuance of consolidated debt obligations (that is, borrowing in the capital markets as a system rather than as individual Banks). Because of the size of these borrowings and the "agency" status of the Banks, lower interest rates are paid by the Banks and such savings are in turn passed on to thrift institution home lenders through lower rates on their borrowings from the Banks.

The Banks are federally chartered entities, all of whose stock is owned by "member" institutions (mostly FSLIC insured, some FDIC insured and a few insurance companies which qualify as housing lenders). However, the Federal Home Loan Bank Board (the "FHLB Board") exercises general supervisory jurisdiction over the Banks, and the System is required to obtain Treasury Department approval for its borrowings. As so structured, the Banks have a dual role and function. Each Bank, in its private sector role, functions much like a private sector banking institution, takes deposits and makes loans to member institutions, borrows money, makes investments and acts as a correspondent banker for its members. In its governmental role, certain employees of the Banks supervise member thrift institutions as agents of the FHLB Board.

These disparate roles should be, and are, strictly separated and "Chinese walled." The private sector type banking operations are governed by the Boards of Directors of the Banks, and handled by Bank employees not involved in FHLB Board supervisory matters. The Board of Directors of each Bank is composed of roughly two-thirds representation from member institution elected members and one-third FHLB Board appointed members. A Bank's Board of

Directors is never advised or consulted with respect to the Bank's supervisory role.

Although it is difficult to quantify precisely the contribution of the Banks and the Federal Home Loan Bank System to "economical home financing" (the charge set forth in their enabling legislation), a few facts may be helpful:

- in 1932 when the System was established, only 42% of Americans were living in owner-occupied homes, whereas now approximately 65% do;

- thrifts originated 50% of the home mortgages provided in 1988 and held in portfolio 40% of outstanding home mortgages;

- the annual value of the reduction in cost of funds to member institutions by use of Bank advances rather than alternative financing amounts to $250-280 million;

- thrift institutions rely significantly on the Banks; Bank stock owned by RAP solvent thrifts amounts to 1/3 of their tangible net worth and dividends paid to these institutions by the Banks have annually exceeded one billion dollars for each of the past two years; in 1988

those dividends accounted for 47% of their net income and,

- for many thrift institutions, the Banks are the only reasonable rate long-term credit source which can also provide short-term credit to alleviate liquidity crises.

Despite their public functions, the Banks are conservatively managed to avoid loss, require adequate security for loans, maintain a significant "legal reserve," possess more capital than any other banking organization in the United States and constitute (as a system) the second largest banking corporation in the U.S.

Appendix 2 provides certain additional facts regarding the Banks and Appendix 3 provides a comparison with the Federal Reserve Banks.

APPENDIX 1

Federal Home Loan Bank of Boston (District 1)

- Connecticut
- Maine
- Massachusetts
- New Hampshire
- Rhode Island
- Vermont

Federal Home Loan Bank of New York (District 2)

- New Jersey
- New York
- Puerto Rico
- Virgin Islands

Federal Home Loan Bank of Pittsburgh (District 3)

- Delaware
- West Virginia
- Pennsylvania

Federal Home Loan Bank of Atlanta (District 4)

- Alabama
- District of Columbia
- Florida
- Georgia
- Maryland
- North Carolina
- South Carolina
- Virginia

Federal Home Loan Bank of Cincinnati (District 5)

- Kentucky
- Ohio
- Tennessee

Federal Home Loan Bank of Indianapolis (District 6)

- Indiana
- Michigan

Federal Home Loan Bank of Chicago (District 7)

- Illinois
- Wisconsin

Federal Home Loan Bank of Des Moines (District 8)

- Iowa
- Minnesota
- Missouri
- North Dakota
- South Dakota

Federal Home Loan Bank of Dallas (District 9)

- Arkansas
- Louisiana
- Mississippi
- New Mexico
- Texas

Federal Home Loan Bank of Topeka (District 10)

- Colorado
- Kansas
- Nebraska
- Oklahoma

Federal Home Loan Bank of San Francisco (District 11)

- Arizona
- California
- Nevada

Federal Home Loan Bank of Seattle (District 12)

- Alaska
- Guam
- Hawaii
- Idaho
- Montana
- Oregon
- Utah
- Washington
- Wyoming

APPENDIX 2

Ten Important Facts About the Federal Home Loan Banks
(all data as of 12/31/88)

1. FHLBank assets: $175 billion
2. FHLBank loans to S&Ls: $153 billion
3. FHLBank capital: $15.5 billion
4. FHLBank debt: $136 billion
5. FHLBanks' purpose is to promote economical home finance by making loans to S&Ls
6. FHLBanks are owned by S&Ls
7. FHLBanks have no government or taxpayer money
8. FHLBanks borrow in the capital markets
9. FHLBanks need impeccable credit

APPENDIX 3

COMPARISON OF FEDERAL HOME LOAN BANKS TO FEDERAL RESERVE BANKS

Comparison Category	Federal Home Loan Bank (data as of 12/31/88)	Federal Reserve Bank (data as of 12/31/87
1. Purpose	Promote economical home finance	Manage money supply Lender of last resort Correspondent services
2. Total assets	$175 billion	$276 billion
3. Total capital	$15.5 billion	$4.8 billion
4. Identity of shareholders	Savings and loans Savings banks	Banks
5. Amount of capital shareholder must purchase	Shareholder must purchase FHLB stock equal to approximately .8% of a shareholder's assets (FHLB shareholder capital investment requirement is four times the Federal Reserve shareholder capital investment requirement)	Shareholder must purchase Federal Reserve stock equal to approximately .18% of shareholder assets
6. Income paid to shareholders	$1.23 billion	$117.5 million
7. Income paid to shareholders as a percentage of total shareholder income (for year end 1988)	1988 FHLBank income paid to thrifts equaled 47% of RAP-solvent thrifts' 1988 income	Approximately .5% of banks 1988 income came from Federal Reserve Bank dividends
8. Source of monies lent to shareholders	Borrow in capital markets	Print money
9. Outstanding borrowings in national and international capital markets	$136 billion	-0-

Comparison Category	Federal Home Loan Bank (data as of 12/31/88)	Federal Reserve Bank (data as of 12/31/87)
10. Loans to shareholders	$153 billion	$3.8 billion
11. Number of banks	12	12

March 20, 1989

POSITION PAPER #1

RE: Independence of the Federal Home Loan Banks

Under FIRREA, the Federal Home Loan Banks ("Banks"), through the FHLBB, would cease to be independent and would be subject to Treasury oversight. We believe that FIRREA adopts the wrong structure by placing the Banks under Treasury's direct supervision.

Treasury oversight would compromise the lending role of the Banks due to a fundamental conflict between the Banks' mandate and Treasury's concerns with overall macroeconomic and budgetary issues.

Putting the Banks under political control is bad public policy. Other specialized providers of credit and liquidity to particular parts of the economy have been purposely made independent of direct Treasury control. The Banks operate with the specific mandate to promote economical home financing by making advances (loans) to member institutions. Treasury, however, has historically shown an institutional opposition to credit allocation, and in particular to any special credit allocation towards housing. Such a bias will over time frustrate the Congressionally established purpose of the Banks to foster home ownership. In addition, Treasury control of the Federal Home Loan Bank System would give the Treasury a way to countermand monetary policy actions of the Federal Reserve Board -- by, for example, dictating the nature, amount or timing of investments by the Banks.

The proposed restructuring of the FHLBB as a bureau of the Treasury presumably is in response to charges that the FHLBB is controlled by the industry it regulates. Without debating the merits of this charge, the Administration proposal addresses this concern by vesting in the Federal Deposit Insurance Corporation regulatory oversight over thrifts through the deposit insurance function and by providing for public interest directors on the Boards of the Banks.

The following could be proposed as an alternative to the restructuring of the FHLBB as a bureau of the Treasury to preserve the independence of the FHLBB and the Banks.

The current independent structure of the FHLBB should be retained, and, in fact, enhanced. The FHLBB should be expanded from a three-member board to a five-member or seven-member board. Each of the members would serve a staggered ten-year term and would be subject to removal only for cause. The Chairman and the Vice Chairman would be Presidential appointees, but FHLBB members would not be required to be members of a particular political party. One or two of the FHLBB members, other than the Chairman and the Vice Chairman, could be from other federal agencies such as the Chairman of the FDIC, the Secretary of Treasury or the Secretary of HUD.

March 20, 1989

POSITION PAPER #2

RE: Funding

Section 502 of FIRREA requires the establishment of the Resolution Funding Corporation ("REFCO"), which will be used to fund the Resolution Trust Corporation. The Banks are given the responsibility for funding the principal of the bonds REFCO will issue, as well as major responsibility for paying the interest on the bonds.

FIRREA requires the Banks to make an initial contribution of substantially all of their retained earnings as of December 31, 1988, an amount equalling nearly $2.1 billion, plus the Banks' prior FICO contribution of approximately $500 million. In addition, the Banks must contribute an annual amount of $300,000,000 from 1989 forward.

The Banks have previously indicated a willingness to contribute their retained earnings accumulated over the past 50 years to assist in resolution of the FSLIC problem and to continue to pay approximately 10% of their earnings to support the Bank Board regulatory functions. The FIRREA provisions go well beyond that, however, imposing on the Banks an annual contribution of $300 million, irrespective of the amount of Bank earnings.

On March 13, 1989, Secretary of the Treasury Brady, in a speech before the National Association of Home Builders, stated that the $300 million to be paid annually by the Banks would be from funds not available for dividends and, therefore, would not directly reduce the earnings of the Banks' shareholders. FIRREA must be amended to achieve this effect.

The impact of these contributions will vary significantly from Bank to Bank. Assuming the legislation is redrafted to permit the Banks to pay dividends from legal reserves, the effect of the contributions will be to reduce Bank dividends on average by 50% -- although the dividends paid by some Banks will be reduced to 1% of their current level.[1] In 1987 and 1988, the Banks were able to pay dividends to their stockholder thrift members in excess of $1 billion each year. Such dividends represented 47% of the earnings of RAP solvent thrifts in 1988. Thus, member thrifts will lose a significant source of income at the same time FIRREA imposes upon them higher capital requirements and higher insurance premiums.

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[1] In contrast to the accounting treatment given to previous Bank investments in FICO, it appears that GAAP accounting will require the Banks to expense all REFCO and future FICO contributions. If so, dividends to members would be substantially eliminated unless the Federal Home Loan Bank Act is amended to permit payment of dividends from legal reserves.

Dividends on Bank stock are one of the most significant advantages of membership in a Bank. Many members hold more Bank stock than they are required to by statute, thus increasing the capital base of the Banks that support the Banks' lending operations. It is likely that if dividends were cut back, as they necessarily would be under FIRREA, those institutions which could withdraw from Bank membership would do so, and members holding excess stock would sell it back to the Banks.

A decrease in their membership base would necessarily impact the profitability of the Banks -- they would have fewer borrowers, and fewer purchasers for their stock. More significantly, members with optional shares would attempt to divest themselves of any shares they hold in excess of statutory requirements. This could lead to a downward spiral -- with fewer members and less paid-in capital, the Banks would have decreased earnings to apply toward their REFCO and FICO obligations. As these obligations required ever-larger percentages of the Banks' earnings, dividends would be slashed further, leading to more membership and capital loss. In turn, the Banks would have to cut their lending operations as they would lack the capital to support their borrowings from the capital markets. Ultimately the Banks would become incapable of fulfilling their function of providing funding for FICO and REFCO, let alone funding liquidity for the housing finance industry.

In addition to the impact on dividends, FIRREA will adversely affect the ability of the Banks to raise further funds in the capital markets by eliminating the legal reserves of the Banks. Under the Federal Home Loan Bank Board regulations[2/] pursuant to which the Banks' have issued their Consolidated Obligations, the Banks may not issue consolidated bonds in excess of 12 times the total paid-in capital and Bank reserves. Thus, FIRREA jeopardizes the Banks' ability to provide liquidity to the housing industry beyond current levels.

In order to meet the objective stated by the Secretary of Treasury that dividends not be reduced, the Banks believe their initial $3 billion contribution will have to be stretched out over seven to ten years, and that their $300 million contribution out of earnings should commence thereafter.

[2/] See 12 C.F.R. §§ 506.1 and 506.6.

March 20, 1989

POSITION PAPER #3

RE: Expansion of Access to FHLBank Services -- Mitigating the Effects of Changes in the QTL Test

Expansion of Bank Membership.

The Federal Home Loan Bank Board and other witnesses testifying before the Congress on FIRREA have advocated expansion of access to Federal Home Loan Bank services to commercial banks and credit unions.[1] The Banks support such expansion of Bank membership provided the new members meet the statutory requirement applicable to all current members that they demonstrate a commitment to economical home financing. Both the earnings of the Banks and the Banks' role in facilitating economical home financing would be enhanced if the Banks were permitted to make advances to an expanded class of shareholders. This expansion would be particularly useful to smaller community banks and rural institutions that do not have access to capital markets.

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[1] Those so testifying have included U.S. Taxpayers on the S&L Crisis, the Independent Builders Association of America, the National Association of Home Builders, the Mortgage Bankers Association, the National Association of Realtors and the National League of Insured Savings Institutions.

Mitigating Effect of Changes in the QTL Test.

One of the changes proposed by FIRREA in the QTL test[2] is to require a member institution failing the QTL test to become ineligible for any further Bank advances, and to repay all outstanding advances promptly. The Banks believe this is both punitive and counterproductive.

Under CEBA (enacted by the Congress in 1987) a member institution that fails to maintain QTL status has its eligibility to receive Bank advances reduced proportionally with the decrease in the member's investment in qualified thrift assets. We are aware of no reason to change current law to bar institutions that show a substantial commitment to housing, but that do not fully satisfy the QTL test, from obtaining any Bank advances. The current law's proportionality approach provides a sound balancing of Congressional objectives.

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[2] The QTL test specifies that thrifts must maintain 60% of their assets in certain "qualified" thrift assets.

March 20, 1989

POSITION PAPER #4

RE: Payment of REFCO Administrative Expenses by the Banks

Under FIRREA, the REFCO would be established in order to provide funds to the Resolution Trust Corporation ("RTC") to enable the RTC to manage and resolve insolvent thrift institutions. REFCO would be largely patterned after FICO; however, the Banks' liability for certain expenses of REFCO would be much greater than the Banks' liability for similar expenses incurred by FICO.

The Banks are required to pay the administrative expenses of FICO under the current provisions of the Federal Home Loan Bank Act. However, administrative expenses are defined to exclude issuance costs and custodian fees. Issuance costs encompass the issuance fees and commission expenses incurred in connection with the issuance or servicing of any FICO obligation, including the legal and accounting fees, trustee fees, printing and advertising expenses incurred in connection with an offering of FICO securities. Custodian fees include fees and expenses incurred by FICO in maintaining segregated accounts. These provisions would not be amended by FIRREA.

Under FIRREA, however, issuance costs and custodian fees would be included in the administrative expenses of REFCO to be paid by the Banks. These expenses have been substantial in the case of FICO and there is no reason to believe that they would not be likewise substantial in the case of REFCO. Thus, the liability of the Banks for REFCO expenses would be much greater than the liability they have incurred for FICO expenses. Moreover, FIRREA includes no limitation on the liability of the Banks for such expenses. When considered in the context of all of the liabilities of the Banks under FIRREA, this further expansion of the Banks' obligations should not be permitted.

The provision for payment of REFCO administrative expenses in FIRREA should be identical to the existing Bank Act provision for payment of FICO administrative expenses. Administrative expenses should be defined in both cases to exclude issuance costs and custodian fees.

March 20, 1989

POSITION PAPER #5

RE: Federal Home Loan Bank Loans to the Savings Association Insurance Fund

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Section 704 of FIRREA would provide that the Banks are authorized, as directed by FDIC and the Chairman of the FHLBS, to lend money to the FDIC, for use of the Savings Association Insurance Fund ("SAIF"), without provision for security for the loan or minimum interest rates. Both security and minimum interest rates are currently required with regard to FSLIC borrowings from the Banks.

These sections as currently drafted could be interpreted to require the Banks to make unsecured loans at below market interest rates. Such a result could jeopardize the credit standing of the Banks, increase the cost of Consolidated Obligations, reduce Bank earnings and impair their ability to support home financing. To avoid these results, we recommend inserting the following at the end of Section 704:

> "; provided, however, that interest on loans to the Savings Association Insurance Fund shall be not less than the Federal Home Loan Banks' current marginal cost of funds, taking into account the maturities involved, and loans from the Federal Home Loan Banks shall be adequately secured"

The above language is substantially similar to the existing statutory limitation on Bank loans to FSLIC.

We understand that the FHLBB has recommended to Treasury that Section 704 be amended as above, except that the Chairman of the FHLBS is given the authority to determine whether loans are "adequately secured".

March 20, 1989

POSITION PAPER #6

RE: FDIC Receivership Powers

FIRREA would give the FDIC broad authority when it is appointed receiver of closed insured financial institutions to: (1) repudiate contracts that the FDIC considers, among other things, "burdensome" (sec. 211(2)); (2) enforce contracts despite the existence of an insolvency clause that would, for example, permit acceleration of Bank loans (sec. 211(2)); (3) give the FDIC adjudicatory power with regard to claims against receiverships (thus forcing the Banks to go before the FDIC if an argument under an Advance Agreement develops between a Bank and the receiver) (sec. 211(10)); and (4) limit the FDIC's liability to a claimant against a receivership estate to an amount equal to what the claimant would have received if the FDIC had liquidated the insured financial institution without regard for any diminution in value if the estate is not liquidated immediately (sec. 211(10)). Additionally, section 214(4) of FIRREA would prohibit the enforcement of an agreement defeating the FDIC's ownership of an asset that belonged to a financial institution unless certain conditions are met.

These provisions could harm the Banks' contractual and security interests that arise pursuant to Advances Agreements with financial institutions in default. The manner in which the Banks' interests could be harmed and proposed solutions follow. In each case the approach is to exclude the Banks from these receivership provisions of FIRREA.

1. Section 211(2) of FIRREA would create a new section 11(c)(2)(G) of the Federal Deposit Insurance Act ("FDI Act") which would authorize the FDIC to "... disaffirm or repudiate any contract or lease the performance of which the [FDIC] in its discretion considers to be burdensome, or in its discretion considers the disaffirmance or repudiation of which will promote the orderly administration of the financial institution's affairs." This provision is intended to give the FDIC the common law right of a receiver or conservator to disaffirm or repudiate contracts. The provision, however, states the common law right in far broader terms than that right has developed in the bankruptcy area. For example, this provision is broad enough to prohibit a Bank from realizing on the collateral to repay an advance made to a financial institution.

The following language would exclude Bank and Federal Reserve Bank Advances Agreements from coverage under the section:

> "and provided further, that no contract between the financial institution and any Federal Home Loan Bank or

Federal Reserve Bank may be disaffirmed or repudiated by the Corporation".

We understand that the FHLBB has recommended to Treasury that Bank Advances Agreements be exempted from the FDIC's power to repudiate contracts.

2. Section 211(2) of FIRREA would create a new section 11(c)(2)(H) of the FDI Act which would authorize the FDIC to "... enforce any contract entered into by the financial institution to the same extent as the financial institution in default, notwithstanding any provision of the contract to the contrary, which [the FDIC] deems in its discretion to be necessary for the orderly execution of its duties ..." This would allow, despite the existence of an acceleration provision in a Bank Advance Agreement, the FDIC to require advances to remain outstanding and thereby prohibit the Banks from realizing on collateral for Bank advances. Arguably, this section could even require that the Banks continue to make advances to members after they are placed in receivership.

The following language would avoid this result:

> ",Provided, however, that no contract between the financial institution and any Federal Home Loan Bank or

> Federal Reserve Bank shall be subject to this subsection"

3. Section 211(1) of FIRREA would add a new section 11(e) to the FDI Act which would give the FDIC the power to adjudicate claims arising in financial institution receiverships and conservatorships thereby denying a judicial trial on claims brought against a receiver or conservator. This is similar to the power which the FSLIC presently asserts. The FDIC would not, however, be subject to the Administrative Procedures Act ("APA") with regard to the form of the adjudicatory process; it could create its own procedures.

The Banks should be exempted entirely from this section by adding a new subsection (l)(4) as follows:

> "(l)(4) This section shall not apply to the claims asserted against the estate of a financial institution by a Federal Home Loan Bank or Federal Reserve Bank, which claims shall be brought in the district or territorial court of the United States held within the district in which the financial institution's principal place of business is located or where the Federal Home Loan Bank or Federal Reserve Bank is located."

In the alternative, the FDIC should be required to follow the APA. The following language should be inserted prior to the period at the end of the first sentence of section (1)(2), and the balance of section (1)(2) should be deleted:

> "and such rules or regulations shall be in accordance with the provisions of chapter 5 of title 5 of the United States Code. Any hearing provided for in this section shall be held in the Federal judicial district or in the territory in which the home office of the financial institution is located unless the party afforded the hearing consents to another place. Judicial review shall be pursuant to the provisions of chapter 7 of title 5 of the United States Code.

We understand that the FHLBB has recommended to Treasury that disputes concerning Bank advances be exempt from the administrative adjudicatory process.

4. Section 211(10) of FIRREA would create a new section 11(k) of the FDI Act which would limit the FDIC's maximum liability to any person having a claim against the receivership estate to an amount equal to what the claimant would have received from the estate of the financial institution if the FDIC had liquidated the estate. Moreover, if the FDIC elects to operate the institution, it would bear no liability to any creditor for any

diminution of the value of the estate, absent bad faith. The purpose of this section appears to be to deter claims against the FDIC for waste and mismanagement in its capacity as a receiver or conservator.

If the FDIC elected to operate the financial institution for a period of time, the value of a Bank's collateral could deteriorate, thereby causing a Bank a loss if sufficient assets were not available in the receivership to pay all claims at face value. To avoid this result, the section should be modified by inserting the following language in the parenthesis in the first paragraph, after the word "depositors," thereby exempting the Banks from the operation of this section, in the same manner that insured depositors are exempted:

> ", Federal Home Loan Banks and Federal Reserve Banks"

5. Section 214(4) of FIRREA would extend the current section 13(e) of the FDI Act to savings association receiverships. It provides that an agreement defeating the FDIC's claim to title to an asset to be enforceable against the FDIC as receiver must be in writing, executed by the financial institution contemporaneously with the acquisition of the asset by the financial institution, approved by the board of directors of the financial institution (which approval must be reflected in its minutes) and have been continuously an official record of the

financial institution. Although the provision is meant to invalidate "secret agreements,"[1] the language is broad enough to cover Advance Agreements.

Therefore, the following language should be added at the end of the proposed section:

> ", provided, however, that any agreement to which a Federal Home Loan Bank or Federal Reserve Bank is a party will not be subject to this section."

We understand that the FHLBB has recommended to Treasury that Bank Advances Agreements and security interests arising thereunder be exempted from this section.

6. Alternatively, a single amendment can be included to exempt the Banks from coverage of those sections. More specifically, a new section 11(n) could be added to the FDI Act, as follows:

> "No Federal Home Loan Bank or Federal Reserve Bank or any agreement between such a Bank and an insured financial institution shall be subject to the provisions of subsections (c)(2)(G), (c)(2)(H), (e) or (k) of this section."

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[1] S. 413, Section-by-Section Analysis, Cong. Rec. 2379 (1989).

From BARRON'S, 2-20-89
p.6-7; p.20.

Steal of the Century?

The S&L Giveaways, Charges a Critic, Are Just That

By BENJAMIN J. STEIN

THIS is the story of one of the best deals that a free society ever offered to its richest and most powerful citizens—a truly staggering opportunity for a few extremely wealthy persons to effect what is basically a government sponsored, no-risk leveraged buyout on a truly heroic scale, financed with money taken from the ordinary taxpayer. It is a tale that is eerily similar to stories about management buyouts, only worse, and with more people paying the bill. It is a story rooted in the well-publicized disaster that has befallen the nation's savings and loan institutions.

To grasp how these no-risk LBOs came about, it's helpful to go to the roots of the S&L disaster.

When the savings and loan industry was born—they were called building and loans in the old days—it filled a real need. Before the Great Depression, skinflinty commercial banks would not lend on middle-class residential property. So ordinary citizens banded together to form cooperative associations to take deposits from middle-class people and lend those funds out again as mortgages to the same kind of ordinary folk. In the Depression, which saw the failure of thousands of banks and building and loans, the Roosevelt Administration created the two deposit-insurance funds we know today.

Today's troubles began taking shape in the late 1960s. By law, federally regulated S&Ls were, in effect, required to lend long (home mortgages) while borrowing short (most of their lendable funds came from passbook savings accounts). But as inflation began to gather steam, the value of the S&L portfolio, like the value of all fixed-rate, long-term debt, fell. By the early 'Seventies, the first substantial cries and alarms went up about the industry and the federal insurance fund protecting it—an insurance fund that, like its counterpart for commercial banks, had worked perfectly

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since its founding. In 1971, the S&L industry had a negative net worth position of (a comically small) $17 billion. As the inflation of the 'Seventies grew worse, the financial crisis of the thrifts (as S&Ls came to be called with unforeseen irony) faced ever larger losses on their loan portfolios.

In addition, they were savaged by high tech, which came in the form of money-market mutual funds. These devices aggregated high-yielding financial instruments like jumbo CDs, commercial paper and government notes and then allowed the small investor to own a piece of the high-yielding pie. With computer-driven data-processing, customers were allowed to write checks on these money funds, and to receive high interest as well. Computers matched up maturities and flows of funds in and out, and generally made possible extremely complex bookkeeping that had not hitherto been available.

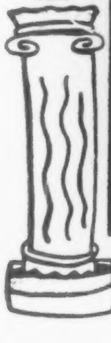
The effect on banks and thrifts was massive and horrible. Money was sucked out of banks and thrifts and into money-market funds by the hundreds of billions of dollars. Combined with the effect of inflation, which had reached double digits by the late 'Seventies, the thrifts especially (with their long-term loan assets) were in intensive care.

The proposed remedy was two pieces of legislation. The 1980 Depository Institutions Deregulation and Monetary Control Act gradually phased out interest rate ceilings on deposits and allowed S&Ls to make consumer loans of various kinds. The Garn-St Germain Act of 1982 further loosened the restraints on S&Ls, allowing them to enter more commercial areas and to explicitly offer money-market fund deposits.

The legislation in question did not by any means kill the S&L industry all by itself. (By some measures, the industry was already dead: In 1981, the market value of the industry's assets was already $150 billion less than its liabilities. It's worth noting that this sum is greater than even the most dire estimates of how much the cumulative losses of the S&Ls are right now; the disinflation of the mid-1980s did in fact salvage a good part of the S&Ls' asset portfolios.) In fact, properly handled, the new freedom of the S&Ls might have enabled them to better match assets and liabilities and establish themselves on a sounder footing.

However, along with the new flexibility came an avalanche of unhindered greed. Throughout America, but particularly in the Southwest, real-estate developers bought or founded S&Ls, which in turn loaned to the developers' own projects and affiliated ones. When

Robert M. Bass



Ronald Perelman

Eddie Adams/Gamma-Liaison

the projects were done, the same S&Ls provided new, long-term "take out" loans, which effectively bought out the developers at handsome profits.

In a series of dance steps that foreshadowed today's gigantic S&L LBOs, the builders/thrift owners invested a tiny slice of equity. Using federal deposit insurance, the builders/thrift owners/LBO creators got low-rate debt to put into their housing developments and shopping centers. If the developments were successful, the wheelers and dealers walked off with fortunes. If the deals tanked—as many of them did—the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corp. ate the loss.

Thus was created the forerunner of today's far larger and somewhat different S&L LBOs. The basic idea was born—that the leverage in the deals would be provided by depositors, lured to lend at low rates by federal deposit insurance, and therefore that Other People's Money would be available at super-low rates. If the collapse of the oil patch showed how fragile real-estate booms were, it most certainly also showed how nice it was to have Uncle Sam underwrite your leverage when you felt like making deals.

Public policy contributed to the mess. The government in Washington failed to hire adequate regulatory staff or replenish the reserves of the Bank Board or FSLIC even as the S&Ls in the Southwest continued to slide into catastrophe compounded by oil patch collapse, poor management, and out and out self-dealing and theft.

This led to the disaster that is now unfolding before our eyes. As the unfunded liabilities of the S&Ls and their insurer mushroomed, the opportunity for chaos grew correspondingly until by late 1988, the situation was truly desperate at the S&Ls and at the Federal Home Loan Bank Board.

The cleanest, fairest way to handle the insolvent thrifts with aggregate unfunded net worth deficits of over $100 billion would have been to shut them down and pay off the insured depositors and then attempt in a careful way to liquidate the loan portfolio. Of course, with virtually no reserves and 100 billion smackers in losses, the Bank Board could not do that.

Nor were there enough healthy thrifts (there I go again) around willing to pick up the dead institutions. Even the healthy thrifts would, of course, have wanted to be paid for the difference in value between the assets and liabilities of the sick thrifts. In the end, if that had to be done quickly, the Bank Board and its insurance fund would still have been bankrupt.

The FHLBB had a few assets of its own. It was an instrumentality of the U.S. government, a top credit risk. It used that camouflage to issue certificates and notes that were really backed only by a hope and a prayer. When issued to insolvent thrifts, they were counted as fully performing assets. Later, they were allowed to be counted as actual capital at some institutions.

Eventually, however, these notes and certificates themselves mounted up to many times the remaining reserves in the FSLIC. The ability of the Bank Board even to service the interest on the instruments was in doubt, and their very legal validity was questioned.

At this point, the basic outlines of a last desperate way to put off apocalypse began to appear. This last desperate maneuver had the distinct look of an LBO, but an LBO laden with goodies that hardly any of even the very best private-industry LBOs could hope to duplicate.

One of the few weapons that the Bank Board had remaining was to offer tax breaks to potential acquirers. Obviously, the dying and dead thrifts could not use the immense losses they had accrued to offset federal income-tax liabilities for the basic reason that they had no income. But a wealthy buyer could use them to great advantage at the right price. A Ronald Perelman or a William

Simon could handily use the tax losses.

With extraordinary ingenuity, the Bank Board had persuaded Congress to allow the acquirers to use the great bulk of the accrued tax losses of the previous owners. The beauty of the deal was that while acquirers would buy thrifts with multibillion-dollar nonperforming loan portfolios, and while those portfolios had generated the desirably transferable tax losses, the acquirer would have absolutely no exposure at all on those nonperforming assets.

That is, the acquirer got the tax losses. The taxpayer got the real losses, as the government assumed 100% of the loss on those bad portfolios. The acquirers got the good part. The taxpayers got the bad part, as the bad loans were shoveled into new spinoffs of the acquired thrifts, with the government promising to pay for all of the difference between the assets and the liabilities associated with them.

If the S&L price were low enough, and it was, the acquirers were buying tax losses with pennies on the dollar. From Day One, the acquirers were ahead, just on the tax losses.

As the Bank Board and FSLIC auctioned off the troubled, dying, and dead thrifts, the acquirers were not buying cadavers. They were buying juicy tax savings that any taxpayer in the world would have loved to have. For purchase prices in the tens of millions, acquirers got tax breaks in the hundreds of millions. It was, so to speak, a steal.

(Of course, the steal was not free. It was a steal from someone. In a sense, although highly indirect and perfectly legal, it was a steal from the taxpayers. As the acquirers got to pay greatly reduced federal income taxes and other taxes, the taxpayers absorbed the loss through a larger deficit, reduced government services, or new taxes. The key point for the Bank Board is that they did not have to pay right away and up front for the acquisitions. Mr. Tax Loss, the guy who used to be called John Q. Public, paid.)

The Bank Board, in fact, was able to make the deals even richer for the potential acquirers. Not only would the agency "guarantee" (with money it did not have) the losses on the nonperforming portfolio. It also "guaranteed" the performing portfolio against loss. That is, when a Perelman or a Bass or a Simon bought into a "troubled" thrift (sort of like a troubled Franco), the Bank Board guaranteed that, should interest rates move adversely and lower the value of the performing assets, the Bank Board would make up the loss if the S&L found itself illiquid.

The deal was mouth-watering. The acquirers made money on tax breaks right off the bat. They had no exposure on the bad loan portfolio. They had very little good asset exposure. In some deals, the minimum rate of return after cost of administration and capital was also guaranteed.

In many ways, the acquirers were looking at something a lot like the Golden Fleece. Of course, there was still potential for loss. The Bank Board did not stand behind losses on portfolio assets acquired after the acquisitions. But those would by definition be small compared with what was guaranteed. And, again, the acquirers made money from the first minute on the tax losses.

But the deal's good points were just beginning. The real El Dorado lay farther on. It had to do with the rate of return on the good assets.

From the moment an acquirer signed the papers, he would be able to deduct already accrued losses (certainly not of the full asset loss, but of the bulk of it) of, say, $1 billion. Against a combined corporate tax rate of about 40%, he would be saving about $400 million in year one. For his out-of-pocket outlay of $50 million, he would have made a return of eight times.

But a well-run S&L (and the Perelmans, Basses and Simonses of this world run things well, and only well, which is how they got where they are. I have been puzzled about why Carl Icahn

William Simon

James Pozarik/Gamma Liaison

hasn't bought himself an S&L) easily earns 1% on assets, even after the cost of capital, including the debt of the holding company. Thus, the good $10 billion portfolio might throw off $100 million in earnings.

Even a fairly well-run S&L throws off 0.5% on assets. To me, this looks like $50 million on a $10 billion pool of good assets. The lucky acquirer would be making 100%-200% per year on his equity. If he could keep up making this much for a few years, and even make it grow a little, he could capitalize the growth and sell the company back to the public.

If he could make $100 million per year consistently (and lots of S&Ls make that kind of return), he could sell out at 10 times earnings, or for about $1 billion. On his $50 million out of pocket, he got tax savings of hundreds of millions, and a good shot at cashing out for a nine-figure sum.

Small wonder that the big names of modern LBO lore were drawn to the S&L crisis. It offered them, in effect, a government-backed LBO. The equivalent of the debt in a private LBO was the depositors' money. However, in a private LBO, high rates must be paid on the leverage. In the S&L LBOs, the government backed the debt, which was the depositors' liabilities. That meant that the leverage part of the deal cost 5%-9%, instead of 12%-15%—and there was no need for giving warrants to the Milken brothers.

(Indeed, the Bass acquisition of American Savings sought to make a sort of LBO pyramid. Bass sought authority to use American to form a merchant bank to do still more LBOs—with money provided at passbook rates. This delightful notion was vetoed, supposedly by honchos at the Federal Reserve Board, but in return for losing that yummy merchant-banking scenario, Bass's equity infusion was lowered by about $200 million. I suspect that the notion of transforming Jimmy Stewart's neighborhood S&L into an engine for further LBO transactions on the cheap is far from extinct.)

It was a sweet shot.

To be sure, Chairman M. Danny Wall and the Bank Board cleverly required some rebate of the sweetness. The rebate took the form of reducing the guarantee on the portfolio in small part in return for the tax savings, and for dealing the taxpayers a slice of the equity in the new S&Ls, itself a new departure in government venture capital.

And, there were some untidy parts of the deal, to say the least. For one big thing, while the Bank Board and the FSLIC "guaranteed" the losses on the bad parts of the S&L portfolios, those agencies (again) did not have enough reserves to actually cover such debits. The bad loans could be put into an S&L with a new name. But the accrued losses in the new boxes could not be paid except bit by bit by bit. The notion that they were going to be paid, or that anything other than just sweeping them under the rug was taking place, was pure fantasy.

By the same token, the Bank Board and the FSLIC "guaranteed" that some acquirers of the defunct S&Ls would make a stated return on assets. But whether they had the reserves or the income to in fact make good on those promises was very much in doubt—not as a matter of good faith, but as a matter of basic arithmetic. Still, if the Bank Board and the FSLIC turned out not to have enough money to cover this promise, well, that was somebody else's problem. In every meaningful way, the government handed wealthy, aggressive, quick-thinking entrepreneurs a government-backed LBO. Even more wonderful, in 1988, the Bank Board and the FSLIC were giving out money for nothing, or almost nothing—at least to the big boys. They were way ahead on the tax angle.

By my humble calculations, just the forgone tax cost to the Treasury from the Bass-American Savings deal would have paid for several thousand regulators and investigators for about five years. The forgone tax collections from all of the S&L deals would have paid to hire a thoroughly competent staff of regulators for the balance of the century.

One of the tragedies associated with these transactions is that they display such astounding inequity between hundreds of millions of ordinary citizens and a few billionaires. But the tragedy that should make taxpayers truly gnash their teeth is that the giveaways do not ultimately save a dime—and in the long run will be far more expensive than just paying off the depositors would have been.

Over time, the net worth deficit of the S&Ls—that is, the gap between the value of their assets and the value of their liabilities—will still have to be paid off by the taxpayers. The mergers, acquisitions and bailouts will not improve that situation by one iota. The bailouts, in fact, make it worse, in that the taxpayers now have to make up the tax subsidy as well as the portfolio losses. Further, to add to the government's losses, which is the taxpayer's losses, the bailouts are so cumbersome and attention-getting that they divert the government from closing down the hundreds of other S&Ls still open. Those S&Ls, like their fallen comrades before them, are still offering huge rates on government insured deposits. That skews the whole rate structure of the financial sector. As the dying S&Ls bid up the cost of capital to keep themselves afloat day by day and meet minimum asset requirements, the healthy, well-managed S&Ls are forced to compete and to pay irrationally high rates. In turn, this drags other S&Ls into financial trouble, and starts again the whole cycle of return on assets not keeping pace with cost of liabilities. As it is, the present cost is high enough: $100 billion or more. In the whole history of the United States, there is no precedent for a loss of that magnitude in a single episode of mismanagement and idiocy. One hundred billion dollars is more than the total wage of all the public school teachers in America. It is about the total income of all the active-duty soldiers, sailors and airmen in the U.S. armed forces.

As this is being written, the new Bush Administration shows signs of actually addressing the problem in workmanlike terms. The President has proposed replenishing the fund for insuring S&Ls. He has proposed stricter capital requirements and better regulation of the S&Ls. He aims to place control of the FSLIC under the FDIC. He has, in a word, suggested that the government do what it should have done long ago—close the bad S&Ls, pay off the depositors, and take steps to see that the problem does not occur again.

To some extent, this reflects credit on President Bush. To some extent, it reflects only that the problem had become too acute to be ignored any longer, much as one might wish to do so. After all, you can pretend that the Japanese planes are only sightseeing for a while. When the bombs start to fall on Hickam Field, you can't pretend any longer.

It's interesting to note, though, that we may not have seen the last word on the late-1988 S&L LBOs. Under the Bush plan, the government would create the Resolution Trust Corp. to liquidate or merge insolvent thrifts. As part of its charter, it would "review all means for reducing costs under existing deals, including through the exercise of rights to restructure such agreements." That could mean the terms of the notes given by the Bank Board to the acquirers.

One shouldn't be too angry with the Basses and th Perelmans. They did nothing illegal. Who of us, offered something for nothing, would turn up his nose? The rich get that way because they know how to make the most of opportunities. The government handed them the steal of the century. ■

PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART IV OF IV

WEDNESDAY, MARCH 15, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Shelby, Graham, Garn, D'Amato, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me invite our first panel of witnesses to come to the table: Mr. Robert Gnaizda, Miss Michelle Meier, and Miss Peggy Miller. We are pleased to have you this morning.

I have a brief opening comment and then I want to yield to my colleague, Senator Dixon, for any comments he may wish to make.

I welcome everyone that's here this morning. This is our 16th day of hearings on the FSLIC issue and we are in the process of concluding our hearings this week. So we will move from the hearing phase into the legislative drafting phase very shortly.

This morning the committee will hear from a panel of consumer groups and then from two major credit union associations that will follow in a second panel.

I am particularly interested in hearing the reactions of our consumer witnesses to the following proposals that I have stressed throughout these hearings.

One would be increasing a thrift's involvement in housing finance by strengthening and clarifying the qualified thrift lender test. I believe the qualified thrift lending percentage should be increased from 60 to 70 percent and the focus of the test should be narrowed to concentrate more directly on housing finance.

Second, if an institution receives a specialized and subsidized thrift charter, it should be encouraged to devote more of its portfolio lending to the individual consumer, family and community needs.

Third, the Federal deposit insurance should not back risky activity engaged in by State-chartered thrift institutions. I have strongly suggested that Congress should limit by statute the power of State-chartered S&L's to those expressly authorized for Federal savings and loans as such. Of course, that would involve disconnecting those State activities from any future liability to the Federal insurance fund.

Also, any other activities that are conducted by a savings and loan would have to be conducted in a totally separate fully firewalled affiliate under a holding company type arrangement.

Finally, that the historically close and I think too cozy relationship between the thrift industry and its regulators must be broken up on a permanent basis.

In addition to the reactions of our consumer group witnesses to these suggestions, I look forward to their comments as well as to those of the credit union representatives to the administration's overall proposal and we would welcome any suggestions you have for changes or modifications in the adminstration's plan.

I know that both groups have some specific concerns as it relates directly to the administration plan.

So before calling on our witnesses, let me now yield to Senator Dixon from Illinois.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Thank you very much, Mr. Chairman. First, let me heartily congratulate you on the effort and the time you have spent on these hearings. I know that immediately upon return from our Easter break we will be prepared to turn to markup on this legislation and your contribution I think has been a very substantial one.

I am pleased to be here this morning, Mr. Chairman, as the Senate Banking Committee continues its tightly scheduled hearings on the problems of the thrift industry and I look forward to hearing the testimony of Robert Gnaizda of Public Advocates, Inc., Michelle Meier of Consumers Union, Peggy Miller, the Consumer Federation of America, Al Williams of the Credit Union National Association, Inc., and Kenneth Robinson of the National Association of Federal Credit Unions.

Last month I was pleased and honored to become the new chairman of the Consumer and Regulatory Affairs Subcommittee of this Banking Committee. As several of today's witnesses are important representatives of major national consumer organizations, I wish to extend to them a very special welcome. I believe the committee will benefit from your advice and counsel as you bring a significant perspective to the thrift problems we are reviewing in the committee hearings.

I'd like to add that consumer affairs is only half of the subcommittee's jurisdiction. When I assumed the subcommittee chairmanship we added the second half of its name—regulatory affairs. Of course, broad issues of financial regulation and reform will continue to be handled at the full committee level, but the subcommittee in time will look at some of the nuts and bolts of bank regulation, in addition to its focus on traditional consumer issues.

Mr. Chairman, I appreciate working with you on this thrift legislative package. I commend you again, sir, for your leadership throughout these hearings and in preparation for markup on the bill and I look forward to working with you and other members in the full committee and in the subcommittee. Other subcommittee members I certainly look forward to working with as well.

Consumer organization representatives, I thank you for your testimony today. I want you to know that as Consumer and Regulatory Affairs Subcommittee chairman—and that's a mouthful—my door is open to you and I look forward to working with you in particular on the subcommittee's agenda.

I thank the Chair.

The CHAIRMAN. Thank you, Senator Dixon.

We have a number of other hearings going on this morning that many of the members of the committee are otherwise required to attend, including myself. We have the Finance Committee meeting this morning on the president's budget. We have the Armed Services Committee meeting on the Cheney nomination. We have the Budget Committee where we have several members of this committee who serve on the Budget Committee, including myself, meeting with Energy Secretary Watkins. So we will have members coming and going in the course of the morning.

We would be pleased now to hear from our witnesses and, Mr. Gnaizda, let me start with you.

STATEMENT OF ROBERT L. GNAIZDA, PUBLIC ADVOCATES, INC., SAN FRANCISCO, CA

Mr. GNAIZDA. Thank you, Mr. Chairman and Senator Dixon. My name is Bob Gnaizda with Public Advocates and I am here on behalf of a broad coalition called the "Green-lining Coalition." We represent 16 minority business and minority consumer and homeless groups, mainly from California. These groups have been poorly served, if served at all, by savings and loans over the last decade.

Before I begin, I'd like to introduce two leaders of the coalition. To my far right is John Gamboa, the executive director of Latino Issues Forum, the major Hispanic think tank in the West and a coalition of major Hispanic groups. To his left is Paul Cobb, who is the chairman of the Community Investment Division of the Interdenominational Ministerial Alliance, which includes a large number of black ministers.

We have four interrelated points to make. The first is, we oppose the imposition of any fees on the savings and loan industry. We believe that could be the road to extinction for healthy savings and loans that might otherwise serve our community.

Second, we agree with you, Senator. We need to transform the savings and loan industry from a red-liner to a green-liner. We need to make its primary occupation serving the housing needs of the community.

Third, we agree strongly with Secretary of HUD Kemp regarding the need to link the S&L bailout to a bailout of the homeless and a bailout of the affordable housing crisis.

Fourth, we believe that the bailout of the savings and loan industry and the bailout of the homeless can best be achieved through an alternative revenue enhancement mechanism. We propose, as I will set forth, a $555 billion revenue enhancement over the next 10 years. This will be imposed on the undertaxed and it will not technically be a tax increase, at least as President Bush has defined a tax increase.

We believe that our four points are the best way to a kinder and gentler Nation and the only way to avoid slashing the domestic budget. As you are aware, for example, because of the budget crisis that is facing our Nation, the President has proposed slashing of the WIC program. 150,000 pregnant women will be cut off the program. The housing budget for public assistance is being slashed by $185 million.

We believe that the revenue enhancements we propose will in general affect only the upper 1 percent of our population and, at most, the upper 5 percent.

The first revenue enhancement is to end the millionaire exemption from social security levies. Today a blue collar worker, a headstart worker, or a McDonald's worker pays a social security tax 20 times the rate paid by some CEO's of savings and loans. That's because we have a cap on the income that's subject to social security, $48,000. If all earned income were taxed, we would achieve additional revenue of $44.5 billion a year or $445 billion over the next decade in 1989 dollars. This is technically not a tax increase. It is not a tax increase because under the Reagan-Bush administration on eight separate occasions the social security cap was changed and moved upward from $29,700 to $48,000; and on five separate occasions the tax rate was increased from 6.65 percent to 7.51 percent, and it will rise to 7.65 percent in 1990.

Also, we believe that in examining whether the social security cap should be removed, we must take into account that the social security tax is unfair and the most regressive tax imposed on the working person. It is also being used to offset our deficit to the tune of $52 billion this year and it is expected by 1994 to offset the deficit by $118 billion.

And for a typical 18-year-old working in a ghetto, the social security tax has nothing to do with retirement benefits. In fact, the typical black male will die before he is eligible for social security.

Our second revenue enhancement is to end the unequal treatment of upper middle class persons, vis-a-vis millionaires. That is, end the 28 percent tax rate for those earning over $150,000 and compel them to pay the same rate, 33 percent, that those earning between $70,000 and $150,000 pay. That will raise between $8 to $10 billion a year in additional revenue.

Third, our last revenue enhancement is to eliminate the preferential treatment of luxury homes as opposed to homes for the homeless. That is, end the mortgage deduction for second homes and put a cap on all mortgage deductions. We would set the cap as follows: Twice the regional average for a new first mortgage. That would generate $2 billion a year or three times what we presently provide for the homeless.

We believe that you will find widespread support for these proposals. For example, the Los Angeles Times Mirror completed a survey published on March 9 in the LA Times. The survey included the following question: Do you favor a tax increase for those earning over $80,000? Eighty-two percent of the 2,045 respondents said they either favored or strongly favored a tax increase for those earning over $80,000; and only 5 percent opposed it.

I would also finally like to make a brief comment, Mr. Chairman, on the other matter you asked us to comment on. We concur with you that the cozy relationship between the Federal Home Loan Banks and the savings and loan industry must be eliminated. The appearance alone is disturbing to the public throughout California.

In conclusion, to appreciate our unique perspective on the need for linkage between the S&L bailout and the bailout of the homeless and who should pay for it, we would like you to consider the following. Assuming, as appears more clear every day, that the bailout will cost $110 billion to the taxpayers alone, $110 billion is more than twice the total cost of the Marshall Plan, even after taking into account inflated dollars. It is also ten times the total assets of all minority thrifts. And it is 150 times the total amount dedicated next year to the homeless.

Last, the American people will eventually take into account the fact that for a typical family of four the cost of this bailout could be at least $1,800 per family.

Thank you.

[The complete prepared statement of Robert Gnaizda follows:]

A $550 Billion Dollar Greenlining Plan To Preserve Savings & Loans, Provide Affordable Housing and Help the Homeless

Presented to the Senate Committee
on Banking, Housing, and Urban Affairs
Consumer Panel on Savings and Loan Bailout

Hearings of March 15, 1989

by Robert Gnaizda of Public Advocates, Inc.
on behalf of the Greenlining Coalition:

American G.I. Forum (California)
San Francisco Black Chamber of Commerce
Black Business Association of Los Angeles
Coalition on Homelessness
California Council of Urban Leagues
Chinese for Affirmative Action
Coalition of Bay Area Woman-Owned Businesses
Consumer Action
Filipino-American Political Association
Interdenominational Ministerial Alliance
Latino Issues Forum
League of United Latin American Citizens (Western Region)
Mexican American Political Association
Oakland Citizens Committee for Urban Renewal (OCCUR)
Rainbow Coalition (National Chair)
World Institute on Disability
Yellow Ribbon Task Force

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A $550 Billion Dollar Greenlining Plan to Preserve Savings & Loans, Provide Affordable Housing and Help the Homeless

"HUD Secretary Jack Kemp is right in urging a linkage between savings and loan bailouts and bailouts of the homeless." – George Dean, President, California Council of Urban Leagues

"Congress should just say no to the possible $200 billion taxpayer bailout unless the rich pay their fair share, including a Social Security tax on the earnings of the wealthy." - Mario Obledo, National Chair, Rainbow Coalition

Summary of Testimony[1]

In summary, the Greenlining Coalition: a) opposes the imposition of onerous and counterproductive fees on the savings and loan industry; b) believes that the revenue for the bailout should be raised through eliminating regressive features of our tax system without technically raising taxes; c) supports HUD Secretary Kemp's linkage between savings and loan bailouts and aid to the homeless; and d) believes that the savings and loan industry should be restructured so that it serves the housing needs of all Americans through a conversion from "redlining" to "greenlining," as, in part, proposed by Senate Banking Committee Chairman Donald Riegle.

This testimony is submitted by the Greenlining Coalition. The Coalition consists of sixteen minority business and community organizations represented by Public Advocates, Inc. The sixteen members of the Coalition include the San Francisco Black Chamber of Commerce, the Interdenominational Ministerial Alliance, the Urban League of California, the League of United Latin American Citizens of California, Latino Issues Forum, the Filipino-American Political Association, the Coalition of Bay Area Woman-Owned Businesses, Consumer Action, and the National Chair of the Rainbow Coalition. (See page 8 for the full list of organizations.)

The Greenlining Coalition supports the preservation and revitalization of the Savings and Loan industry, but only if the industry is financially viable and is committed to affordable housing and the development of "greenlining," as opposed to "redlining," lending policies.

The Coalition believes that the most effective resolution of the $110 billion taxpayer-subsidized bailout of the savings and loan industry is through following the advice of HUD Secretary Jack Kemp: the S&L bailout should be linked to an overall resolution of our affordable housing and homelessness crises.

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[1] This testimony was prepared by Robert L. Gnaizda of Public Advocates, Inc., 1535 Mission Street, San Francisco, California 94103, (415) 431-7430. Gnaizda is a 1960 graduate of Yale Law School and was formerly a tax attorney with the U.S. Treasury Department.

Unfortunately, the $110 billion taxpayer bailout of S&Ls will, in effect, "steal" scarce federal revenue from domestic housing and education programs, unless additional revenue is raised. This will jeopardize the President's desire to create a "kinder, gentler nation." For example:

One hundred and ten billion dollars is almost fifteen times the amount the federal government committed to subsidized housing in 1988 ($7.5 billion), and more than 150 times the amount the Bush administration has committed to the homeless for the next fiscal year ($670 million).

The Bush administration's proposal to impose heavy financial burdens on the savings and loan industry is likely to weaken the industry, including minority thrifts that lend in inner cities. This could discourage S&Ls from being committed to affordable housing, as properly urged by Senator Riegle.

The Coalition proposes that $550 billion in additional revenue be raised over the next decade without formally or technically raising taxes, in order to enable the President to achieve his laudable vision of a "kinder, gentler nation." This is referred to as the "Greenlining Plan." The $550 billion would be used to bail out the industry, restructure it toward affordable housing, and ensure that the federal government has sufficient revenue for affordable housing without having to cut, as it presently proposes, other essential domestic programs.

The $550 billion in revenue would come from the following sources and would not violate President Bush's no-tax-increase pledge. The plan would involve little or no financial sacrifice for 95% to 99% of all taxpayers.

1. Social Security Levy on Millionaires: A Key to Financial Stability

The Social Security levy is in reality a highly regressive income tax that is used to offset the federal deficit. Unlike the individual income tax, this tax is totally regressive, since no earned income above $48,000 is taxed at all. As a result, a millionaire pays an effective tax rate of less than one half of one percent.

According to the Congressional Budget Office estimates, as much as $44.5 billion a year in additional revenue could be secured by extending the Social Security tax to all earned income. This extension would thereby end the most regressive features of the Social Security tax, as well as producing $445 billion (1989 dollars) over the next decade.

The removal of the Social Security tax cap should not be considered a tax increase. The Reagan Administration, during the period 1981-1989, approved eight increases in the income level subject to the social security tax, as well as five increases in the social security tax rate. In addition, the President has not opposed the scheduled social security rate increase for 1990. [See chart below]

CHART: SOCIAL SECURITY INCREASES UNDER REAGAN/BUSH

Year	Income Threshold	Rate
1981	29,700	6.65%
1982	32,400	6.7
1983	35,700	6.7
1984	37,800	7.0
1985	39,600	7.05
1986	42,000	7.15
1987	43,800	7.15
1988	45,000	7.51
1989	48,000	7.51
1990 and after	[based on inflation]	7.65

2. *Increase Income Tax Rate on Highest Bracket to 33 Percent*

The second revenue enhancement urged is the imposition of a 33% federal income tax rate on those whose taxable income exceeds $150,000 a year. This would raise between $8 billion and $10 billion a year. This enhancement is technically not a tax increase, since it ensures that the tax code is not regressive for the top one-half of one percent of all taxpayers, who presently pay tax at a lower rate (28%) than workers with taxable incomes above $70,000.

3. *Set Limits on Luxury Home Mortgage Deductions*

The third revenue enhancement would be to eliminate the mortgage deduction for luxury second homes, and impose a cap on the dollar amount of home mortgages subject to a tax deduction. The cap would be twice the amount of the regional median new home mortgage. This is consistent with President Bush's no tax increase pledge, since the 1986 Tax Reform Act set comparable, albeit more modest, restrictions on mortgage deductions. These mortgage provisions would raise two billion dollars a year, or almost three times the President's proposed budget for the homeless.

I. The S&L Bailout Could Crush Inner Cities, Negate Kemp's Commitment to The Homeless, and Destroy the American Dream

"HUD secretary Jack Kemp comprehends what few S&L leaders understand: America's destiny is tied to a partnership between S&Ls, the poor, the homeless, and inner cities" - James Jefferson, President, San Francisco Black Chamber of Commerce

President Bush's proposed budget provides for an inflation increase for the military budget and no inflation increase for domestic social programs such as housing and education. This is because the President does not wish to raise taxes. Thus, the President's budget proposal effectively cuts $9.6 billion in funds for domestic programs. (Center for Budget and Policy Priorities, "The Bush Budget," February 1989, pp. 1-6.)

In fact, the President is so trapped by his "no tax increase" pledge, combined with his commitment to bail out savings and loans, that he has proposed a cut of $100 million in his education budget.[2] This could endanger the President's efforts toward a "kinder, gentler nation" and prevent him from being recognized as "the education president."

Regarding federally subsidized housing, the President is proposing $185 million in cuts from a wholly inadequate $7.5 billion budget provided by President Reagan for last year. This is in conflict with the President's support of HUD Secretary Jack Kemp's commitment to spend more on affordable housing and the homeless.

It is estimated that if the President is to meet even the most minimal housing needs for the poor, an additional $11 billion a year must be allocated just for low-cost public housing. (Washington Post, February 9, 1989, page A-18, based on Congressional Budget Office analysis.)

II. Analysis of $550 Billion Revenue Requirement

"Mister President: Read our lips. Taxing the income of the wealthy to the same degree workers are taxed is not a tax increase." -- Selwyn Whitehead, President, Coalition of Bay Area Woman-Owned Businesses

The key to a savings and loan bailout that produces affordable housing and a resolution of the homeless crisis, as advocated by Jack Kemp and President Bush, is to raise sufficient revenue. As set forth in Section I, the President's present proposal will require cutbacks of almost ten billion dollars in critical housing, education and health measures for the poor and middle class. Further, the President's no-tax-increase pledge prevents any resurrection of the pre-Reagan era federal commitment to ensure an adequate supply of affordable housing.

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[2] Further, despite the President's commitment to Head Start for all low-income four-year-olds, only 22%, or one in five eligible children, will participate in 1990.

All revenue increases proposed by the Greenlining Coalition are consistent with, if not identical to, revenue increases secured during the Reagan Administration with the approval of then-Vice President Bush. Thus, none are technically tax increases and all are consistent with Bush's "no tax increase" pledge. In addition, they will have the support of 95% of Americans[3] and involve no unique financial burdens on the savings and loan industry.

All of these revenue proposals are predicated upon the fact that the poor and the middle class are not responsible for the S&L crisis, have had their taxes increased over the last few years (partly due to the near doubling of the highly regressive Social Security tax levy since 1981), and the wealthy have gained the most and stand to gain the most from an effective bailout of the S&L industry.

A. *Social Security Levy on All Earned Income: $44 Billion a Year In Revenue*

At present, virtually all blue collar workers pay a Social Security tax at a rate twenty times higher than paid by a typical "Fortune 500" CEO.[4] This is because earnings only up to $48,000 are taxed at a rate of 7.51% under our highly regressive Social Security tax system.

During the Reagan Administration, the Social Security tax rate increased five times from 6.65% to 7.51 percent. (It is also scheduled to be increased during the first year of the Bush Administration to 7.65 percent.) During this same Reagan/Bush period, the income subject to the Social Security levy has been increased eight times, or by 62%, from $29,700 to $48,000.[5]

If all earned income, including all the earned income of top S&L executives, Fortune 500 CEOs, and other millionaires, were taxed at a 7.51% rate, we could generate $44.5 billion in additional revenue per year, or over $445 billion, in 1989 dollars, over the next decade.[6]

Another important reason for generating $445 billion[7] over the next decade from Social Security is that Social Security is mostly an income tax, unrelated to retirement benefits. And, according to the Center on Budget and Policy Priorities, an estimated $56 billion in Social Security surplus will be used to reduce the general federal deficit for the fiscal year 1989. In 1994, the Social Security surplus may be equal to the entire federal deficit, since up to $118 billion is estimated to be available as an offset against the deficit. As the following chart demonstrates, the removal of the cap is consistent with the President's no tax increase pledge.

CHART: SOCIAL SECURITY INCREASES UNDER REAGAN/BUSH

Year	Income Threshold	Rate
1981	29,700	6.65%
1982	32,400	6.7
1983	35,700	6.7
1984	37,800	7.0
1985	39,600	7.05
1986	42,000	7.15
1987	43,800	7.15
1988	45,000	7.51
1989	48,000	7.51
1990 and after	[based on inflation]	7.65

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[3] Two of the three revenue enhancements affect just the wealthiest one percent of taxpayers, and the third (the Social Security increase) will have a substantial impact on less than five percent of all wage earners. See also Gallup Poll of March 8, 1989 regarding the overwhelmingly high percentage of wage earners who support raising the taxes of the undertaxed wealthy.

[4] The tax rate on one million dollars is just one-third of one percent.

[5] In 1981, the Social Security tax was levied on all earned income up to $29,700. The amount of earned income covered by the tax was increased in every single year from 1981 through 1989, where it is now at $48,000. The Social Security tax rate was at 6.65% in 1981, and was raised in 1982, 1984, 1985, 1986, and 1988, and it will automatically be raised to 7.65% in 1990.

[6] This estimate was provided by the Congressional Budget Office to the Coalition's researcher on February 24, 1989. It is based upon an extrapolation based on the proposed increase on the Medicare tax rate to all earned income. The Medicare tax rate increase, which has been proposed to cover all income, would produce approximately $8 billion a year. Its tax rate of 1.45% is less than one-fifth of the total Social Security rate of 7.51 percent. Even if the employer contribution were eliminated, $22.2 billion a year in additional revenue could be raised.

[7] There are two cautionary notes in regard to the exact amount that could be raised by levying a tax on all earned income. The first is that the projections, which are based upon the Congressional Budget office Medicare statistics, include some persons who would not be subject to the levy on income above $48,000. The second is that no additional benefits would be allocated for earnings above $48,000.

B. *Ensuring that the Rich Pay the Same Income Tax Rate as the Upper Middle Class*

For reasons that are not fully known, the Tax Reform Act of 1986 set a maximum tax rate of 33% for those with taxable incomes of up to $150,000, depending on marital status and deductions. For those earning above that amount, the rate was reduced to 28%, thereby creating a uniquely regressive tax structure.

Since the wealthy have been the primary beneficiaries of S&L greed, mismanagement, and fraud, and some have insured deposits of well over a million dollars (divided among numerous S&Ls), it is appropriate that this income group shoulder its fair share of the bailout burden.

According to the Congressional Budget office, $8 to 10 billion per year could be raised by increasing the marginal tax rate to 33% for all upper-income taxpayers. This would raise up to 100 billion in additional revenue over the next decade, in 1989 dollars and eliminate the unfair discrimination that presently exists between those earning $75,000 and millionaires.

C. *Setting Limits on Luxury Home Mortgage Deductions*

A disproportionate percentage of S&L residential lending over the last decade has been to assist the affluent housing patterns of the wealthy. According to the Congressional Budget Office, an additional $300 million a year can be raised by eliminating home mortgage deductions on second homes.

A further $1.4 to $1.7 billion could be generated by denying deductions for any home mortgage where the interest payments exceed $20,000 a year.

The Coalition's proposal is to modify this so that deductions are denied only where the mortgage deduction exceeds twice the median dollar amount of a first-time home mortgage in the region. Most, if not all, of this revenue should be earmarked for affordable housing.

Overall, these home mortgage restrictions would raise twenty billion dollars, in 1989 dollars, over the next decade. This is technically not a tax increase, since similar, albeit more modest, restrictions on home mortgages were included in the Tax Reform Act of 1986 approved by then-Vice President Bush.

III. Transforming S&Ls From Redlining to Greenlining Through Senator Riegle's Approach

"It is a national shame that the typical S&L has less than one percent of the dollar value of its direct loan portfolio invested in blacks residing in black communities." - Paul Cobb, Chair of Community Investment, Interdenominational Ministerial Alliance

"Savings and loans are synonymous with redlining. Unless S&Ls join hands with all Americans to promote a multi-billion dollar greenlining plan to ensure the American dream for all, they may soon be extinct." - Anita Del Rio, Far West President, League of United Latin American Citizens

A recent Federal Home Loan Bank Board study of ten million residential mortgage loans made by savings and loans during the period 1984-1987 showed that blacks were twice as likely as whites, and Hispanics fifty percent more likely than whites, to be rejected for home loans when equally qualified. It also showed that high-income blacks were rejected more often than low-income whites in 85 of the 100 largest metropolitan areas in at least one of the last five years. (Los Angeles Times, January 23, 1989, Part IV, page 2.)

Further, this analysis of ten million S&L loans throughout the nation showed that even well-to-do whites residing in upper-income integrated neighborhoods were rejected as often as whites residing in poor white, non-integrated neighborhoods. (Los Angeles Herald Examiner, January 22, 1989, page D-4.) Another shocking study by the University of Chicago showed that blacks without regard to income are forced to live in segregated housing. (Washington Post, February 9, 1989, page 2).

In California, over the last decade, the vast majority of major savings and loans, including American Savings and Loan (which was recently bailed out by the taxpayers), provided less than one percent of all loans to blacks residing in black communities. The Coalition contends, and is prepared to prove, through FHLBB hearings, or hearings of the Senate Banking Committee, that there is no major S&L in California that has allocated even two percent of the dollar value of all its loans to blacks residing in black communities or four percent to Hispanics living in Hispanic communities.

Savings and loan redlining is in violation of the Community Reinvestment Act of 1977. Any S&L bailout should be conditioned on strengthening the Community Reinvestment Act and ensuring that its terms are vigorously applied. In part, this can be achieved through Senate Banking Committee Chairman Riegle's proposal that S&Ls increase residential mortgage lending. Further, the Chairman's proposal might be enhanced by providing special tax credits and lesser capital requirements for the eleven billion dollar minority-owned savings and loan associations whose primary portfolio is committed to Jack Kemp's inner city revitalization. (It might be noted that 80%, or the vast majority of minority-owned S&Ls are not bankrupt, largely due to their non-speculative inner city residential lending practices.)

IV. S&Ls Have Departed From Their Obligation to Help Fulfill the American Dream

> "During the Christmas week of 1988, the federal government made a gift of $13.8 billion to bail out the savings and loan industry. It spent almost 15 times more in one week on bailing out S&Ls than the total President Reagan has spent on bailing out the homeless." -- Mary Kate Connors, Housing Committee of the Coalition on Homelessness

In the 1960s, savings and loans, particularly California savings and loans, were in the forefront of ensuring that affordable residential mortgages were available. Twenty years ago, over 60% of all residential home mortgages were originated by savings and loans. By the beginning of 1988, this had been reduced to 39%, or a cutback of more than fifty percent. (New York Times, February 20, 1989, page A-14.)

Ten years ago, almost three-fourths (74.4%) of S&L assets consisted of residential mortgage loans. Today, less than one half (45.9%) are in residential mortgage loans.

Equally significant, from 1980 to 1987, the assets of savings and loans more than doubled, from $615 billion to $1.25 trillion. Yet only 20% (20.2%) of this increase was invested in residential mortgage loans. ("Report to U.S. Taxpayers on the Savings and Loan Crisis," by Ralph Nader, February 1989, pp. 14-15.)

As set forth in Section III of our testimony, this decision to abandon the residential home mortgage arena has been compounded by redlining directed at minorities and integrated neighborhoods.

Further compounding S&Ls's straying from their mandate of the 1960s has been the decision of S&Ls to lend primarily to the affluent. In part, this is due to the unaffordability of home mortgages in many areas of the nation. For example, as of the beginning of 1989, only one in ten California families had income sufficient to become homeowners in the San Francisco Bay area.

It is for these reasons that the Coalition urges a major restructuring of the savings and loan industry and a unique commitment by the industry to advance the housing needs of all Americans.

The Coalition believes that this can best be achieved with the support of S&L leadership. Thus, the Coalition has not advanced at this time specific technical suggestions for restructuring the industry, such as placing it under the umbrella of the FDIC or perhaps giving it special tax credits if it advances the cause of affordable housing, the homeless, and the development of inner cities. However, the Coalition strongly supports the March 7, 1989 suggestions of Senate Banking Committee Chair Donald W. Riegle, Jr. and Representative Frank Annunzio suggesting that S&Ls put 70% to 80% of their investments in residential mortgages in the community. (Los Angeles Times, March 8, 1989, IV-2.)

V. Savings and Loan Bailout Could Cost Over $200 Billion in Taxpayer Funds

> "The President's S&L bailout endangers Head Start, nutritional programs for pregnant women, and the needs of the homeless. It also endangers his reputation as the 'education president.' Our proposal for a $550 billion revenue increase is a relatively painless way to produce a 'kinder, gentler nation.'" - John Gamboa, Executive Director, Latino Issues Forum

The adverse impact of the savings and loan crisis on the future of the homeless, affordable housing, health, education, and nutrition programs dedicated to low- and moderate-income Americans is substantial (see Section I).

One month ago, President Bush estimated that the taxpayer cost of the bailout would be under $40 billion. A week later, the President admitted that it would be at least $60 billion. Last week, the Congressional Budget Office estimated that the cost to taxpayers could exceed $110 billion. Time Magazine, based upon the analysis of many experts, suggests that it could rise to $200 billion or more. (Time Magazine, February 20, 1989, page 66.) In part, these disparities have occurred because the President's estimate is based upon an unusually rosy economic outlook that assumes low interest rates and a restoration of full confidence in the savings and loan industry.

The Coalition's Greenlining Plan could help restore confidence in the savings and loan industry, generate sufficient funds to bail out failing S&Ls, and ensure sufficient funds for affordable housing for low-income Americans without "stealing" scarce revenue from Head Start, infant nutrition programs, or other key federal assistance to the needy.

Conclusion

> "An S&L industry that practices "greenlining," as in part urged by Senator Riegle, could enable America to prosper, and enjoy the undisputed support of all Americans." - Alex Esclamado, President, Filipino-American Political Association

The President can raise $550 billion over the next ten years without technically increasing taxes or affecting the tax rates of 95% of Americans. The increase would fall on those who can afford it and those who have benefitted the most from the S&L crisis. President Bush should seize this opportunity to promote a "kinder, gentler nation," without endangering key domestic programs or HUD Secretary Kemp's ambitions affordable housing and inner city programs.

Respectfully submitted,

Robert L. Gnaizda, on behalf of
Greenlining Coalition[8]

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[8] American G.I. Forum, San Francisco Black Chamber of Commerce, Black Business Association of Los Angeles, Coalition on Homelessness, California Council of Urban Leagues, Chinese for Affirmative Action, Coalition of Bay Area Woman-Owned Businesses, Consumer Action, Filipino-American Political Association, Interdenominational Ministerial Alliance (San Francisco Bay Area), Latino Issues Forum, League of United Latin American Citizens (Western Region), Mexican American Political Association, Oakland Citizens Committee for Urban Renewal (OCCUR), Rainbow Coalition (National Chair), World Institute on Disability, Yellow Ribbon Task Force

The CHAIRMAN. Thank you very much for your comments and we appreciate having them and we will make the full statement a part of the record.

Miss Meier.

STATEMENT OF MICHELLE MEIER, COUNSEL, GOVERNMENT AFFAIRS, CONSUMERS UNION, WASHINGTON, DC

Miss MEIER. Thank you very much, Mr. Chairman.

I am Michelle Meier with Consumers Union. By way of introduction, Consumers Union is a membership organization established over 50 years ago. We are also the publisher of Consumer Reports magazine which has a circulation of over 3.5 million.

We appreciate the opportunity to appear before this committee today because we believe that the FSLIC bailout raises very, very important questions for the public and for public policy. We only hope that our testimony today will not fall on deaf ears but that indeed our public policy recommendations regarding this tremendous bailout will be incorporated in the legislation the committee moves in the near future.

We certainly appreciate your interest in moving the FSLIC bailout bill quickly, but because of the size of the bailout and the importance of the public policy issues before us today, we hope that the public interest groups represented here and the others who requested to testify but were unable to—their views will be incorporated in the legislation.

The public has a big stake in three particular issues posed by the FSLIC situation. First is the question of, as you cited, Mr. Chairman, the question of what public purpose the S&L industry should serve in the future. How should we restructure the regulatory system to ensure that they serve unmet needs that wouldn't otherwise be met by the market on its own, to justify this huge bailout and continuing public support for the industry.

Two, the public has a huge stake in what type of safety and soundness reforms we will impose on the industry to ensure that this travesty never happens again.

Three, the public has a huge stake in the question of who should pay and what the increased insurance premium will do to S&L and bank customers, particularly low income and moderate income customers.

My testimony goes into our response to these three questions. I will focus on a couple.

On the question of what purpose the S&L industry should serve in the future, we believe that the S&L industry was begun with truly a noble mission—to provide housing finance to make the American population a population of home owners. It was designed not to serve the middle or upper middle class but more modest persons with housing needs. Hence, the term thrift.

However, we believe that at this point in time the thrift industry has really failed to serve a public purpose and that Congress needs to redefine what public purpose it should serve.

In the last few years the thrift industry has changed its historic role. Its commitment to residential mortgage lending has decreased over time. In fact, in 1985, the S&L industry held only 33 percent of all mortgage loans with nonpublicly insured institutions, institutions receiving no public support, accounting for a large share of the market.

In many respects also, the thrift industry, even as a mortgage lender, fails to meet the needs of the average consumer. For example, the thrift industry accounts for only a very small portion of FHA and VA mortgage originations, with again an uninsured, nonpublicly support industry, the mortgage banking industry, accounting for the vast majority of FHA and VA originations.

According to Federal Home Loan Bank statistics, over the past 2 years the thrift industry has set its fixed rate interest rate for residential loans several basis points higher than its major competitors. So again, it's not pricing its product to particularly accommodate the housing needs of the average consumer.

Our purpose here is not to indict the S&L industry, but as it appears you are, to come to grips with the question of how can we better design the S&L industry so that it can truly serve a public purpose that would not otherwise be served by the free market on its own.

We believe that the S&L industry should serve the public purpose of meeting low and moderate income housing needs by providing subsidized, reduced rate, single and multifamily housing loans for low and moderate income home owners and renters.

Specifically, we propose that the S&L industry through the cash advance program at the Federal Home Loan Banks set aside a portion of the cash advance funds for this type of targeted lending. This is a proposal that's actually modeled on a reduced rate cash advance program for targeted lending that was established by the Home Loan Bank Board in 1978.

Between 1978 and 1983 under this program, almost $10 billion in targeted loans were originated. The interest rate on the cash advances for this targeted program during the time it was alive was capped at 50 basis points below the cost of funds to the Home Loan Bank making the cash advance.

We believe that this program, which was essentially dismantled in 1983, should be incorporated and resurrected in the FSLIC bailout legislation so that the S&L industry has the opportunity and the funds needed to meet low and moderate income housing needs.

Additionally, to serve this targeted community, it's necessary and we highly recommend that the FSLIC bill incorporate some sort of subsidy from outside the industry to provide additional interest rate reductions for the targeted loans. We recommend that the Congress modify the mortgage interest deduction now available to wealthy home owners to redirect the revenues to provide a subsidy for targeted lending.

We also believe that the tax preference given the S&L industry should be used to subsidize this type of lending.

We also hope that this committee will seriously look to providing other incentives for this type of lending. We recommend that S&L's who engage in public purpose lending of this sort get an insurance premium discount that would be offset by increased premiums paid by the balance of the S&L industry.

We also extensively go into our response to the Bush proposal safety and soundness reforms. We don't think that they are sufficient. We think that the Bush administration has given endorsement to repudiating the forbearance principle but forbearance is still rearing its ugly head in the Bush proposal; one, by grandfathering those forbearance agreements that have already been entered into.

We go more into that issue in our testimony and I will be happy to respond to any questions.

The CHAIRMAN. Good. I realize we have got to set time limits as we do here, but I don't want those to cut off what we need to hear. We have other witnesses later in the morning and I appreciate your following the time limits. I want to make sure, however, that if there are any other major highlights in your presentation that you meant to touch on that you have a chance to do so. Is there anything else that stands out?

Miss MEIER. I appreciate that. Well, one of the other points I was going to make actually addresses one of the points you had asked us to make or address—the question of the cozy relationship between the industry and the regulator.

We believe that the Bush proposal doesn't go far enough in terminating that cozy relationship and that the present situation which is continued under the Bush proposal, of having the supervisory staff located within the Home Loan Banks and paid by the Home Loan Banks, which obviously are owned by the S&L industry, is a big problem. We think that that supervisory staff should be paid by the Federal Government.

A corollary thought, though, is that it's very important to provide enough money and resources for adequate examination and that, like with the FDIC, the personnel and payroll limitations otherwise imposed on Federal employees should be waived in this particular circumstance.

[The complete prepared statement of Michelle Meier follows:]

Consumers Union
Publisher of Consumer Reports

TESTIMONY OF
MICHELLE MEIER
COUNSEL FOR GOVERNMENT AFFAIRS
CONSUMERS UNION

before the

SENATE BANKING COMMITTEE

THE FSLIC BAILOUT

March 15, 1989

Consumers Union[1] appreciates the opportunity to testify on one of the most pressing budgetary issues now facing us-- the insolvency of the Federal Savings and Loan Insurance Corporation (FSLIC). We commend you, Mr. Chairman, for recognizing the public's large stake in this issue by inviting a panel of public interest representatives to these hearings. Hopefully, this will mark a turning point in the FSLIC debate, which has been dominated so far by the industry and the regulators.

The amount of public money needed to return the S&L fund to solvency is staggering. Although we appreciate this Committee's interest in moving quickly toward enactment of bailout legislation, several public policy issues must be fully considered before we commit such a huge amount of public funds to rescue a system that has obviously failed to serve its public purpose.

The public has a huge stake in 3 basic issues raised by the FSLIC disaster:

I. What public purpose should insured depository institutions serve in the future to justify this huge public bailout and continuing public insurance, and what mechanisms are needed to ensure future public accountability?

II. What safety and soundness rules should be established to prevent another huge bailout in the future?

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III. Who will pay to shore up both FSLIC and the FDIC in the most progressive manner possible, and how will increased insurance premiums affect the small depositor?

Our testimony addresses all three questions in the order presented. No bailout legislation should move until Congress, the public and all interested parties have had a chance to fully discuss and respond to alternative proposals to address them. Many members of Congress find it distasteful to spend much time on the unpleasant subject of a multi-billion dollar failure of a legislative program taxpayers now must pay for. However, given the costs involved, it is worthwhile spending some extra time doing it right.

I. What public purpose should insured depository institutions serve in the future to justify this huge public bailout and continuing public insurance, and what mechanisms are needed to ensure future public accountability?

THE PUBLIC PURPOSE OF THE S&L INDUSTRY MUST BE REDEFINED

The S&L had noble beginnings. It was established to provide mortgage financing to small depositors, who also had an ownership interest in the mutually organized institution.

Today, the S&L has changed dramatically. Most of the industry's assets are held in thrifts that are organized in the stock form, rather than the mutual form.[2] Thrifts have also diversified their assets. In December, 1977, mortgage assets accounted for 85.6% of the industry's aggregate portfolio.[3] In June, 1987, this figure had declined to 69.7%.[4] In December, 1977, mortgage loans on 1-4 family dwellings represented 69.8% of the industry's assets.[5] In June, 1987, these loans only represented 37.1% of industry assets.[6]

Not only has the thrift industry turned from mortgage lending, but non-thrift firms have entered the mortgage market in impressive numbers in recent years. Indeed, in 1985 the S&L industry held only 33% of all nonfarm residential mortgage loans, while commercial banks held 14% and government-sponsored enterprises and non-insured institutions funded most of the rest.[7]

New firms have not only entered the mortgage market with gusto, but, in many respects, they meet the mortgage needs of the average consumer better than thrifts. For example, S&Ls participate very little in the FHA/VA mortgage guarantee program, accounting for only about 10% of all FHA/VA originations in 1987.[8] On the other hand, mortgage bankers, a group of lenders who receive no public insurance or other special benefit, accounted for about 72% of FHA/VA originations in that year.[9] According to FHLBB statistics, between 1985 and 1988 S&Ls originated fixed-rate mortgage loans at average interest rates that were several basis points higher than loans originated by all of their major competitors.[10]

We are not here to indict the S&L industry. Rather, we present these statistics to emphasize that the public purpose of the industry must be re-examined and re-defined. If we are to bail out the industry, and to stand behind it in the future with deposit insurance and implicit guarantees on Federal Home Loan Bank (FHLB) debt securities, the industry should serve a clear public purpose that the free market would not serve as well by itself.

THE S&L INDUSTRY SHOULD SERVE THE PUBLIC PURPOSE OF MEETING LOW AND MODERATE INCOME HOUSING NEEDS

The financial decline of the S&L industry, and its federal insurer, has been accompanied by a parallel decline in the availability and affordability of housing for our low and moderate income citizens. Given the historic mission of the S&L industry to supply housing finance for our population, we believe that any FSLIC bailout should also direct the S&L industry toward serving the public purpose of meeting these housing needs.

It is shameful that the S&L industry has squandered $90 billion in insured deposits while the unmet housing needs of our population have grown dramatically. It would be more shameful if we bailed out the industry without firmly reestablishing that its purpose is to help meet these needs. These publicly insured depository institutions, because they are publicly insured and chartered to serve a public purpose, should be selected as the delivery system for subsidized single and multi-family housing loans targeted to low and moderate income homeowners and renters.

During the past several years, as the public purpose function of the S&L industry has declined, the unmet housing needs of lower-income consumers have drastically increased. For example, the following figures illustrate the increasing gap between those eligible for federal rental assistance and those who receive it:

INCOME-ELIGIBLE BUT NON-SUBSIDIZED RENTER HOUSEHOLDS

Rental Households with Incomes Under $5,000 Receiving No Rental Assistance

1974: 2.2 million households

1987: 3.2 million households

Rental Households with Incomes In the $5,000 to $10,000 Range Receiving No Rental Assistance

1974: 3.8 million households

1987: 4.7 million households

Source: 1988 Report of the
National Housing Task Force

Additionally, there are an estimated 1.0 million families on waiting lists for public housing, and some lists have been closed to new applicants.[11]

THE FHLB CASH ADVANCE PROGRAM SHOULD HELP S&LS SERVE THIS PUBLIC PURPOSE

As of September 30, 1987, the 12 FHLBs had $120.1 billion in cash advance loans outstanding to their member S&Ls. A year later, this figure had grown to $141.6 billion. Although the FHLBs are able to borrow funds used for cash advance lending relatively cheaply, they relend it at a profit. In this way, the Banks had accrued total capital (capital stock outstanding and retained earnings) of over $15.1 billion as of September 30, 1988.[12]

Some of this cash advance money available to S&Ls through the FHLBs should be earmarked by the FSLIC legislation for public purpose lending to meet low and moderate income housing needs. Such a targeted cash advance program would be modeled after a special cash advance program established by the FHLBB in 1978. That program, the Community Investment Fund (CIF), directed the FHLBs to make reduced rate cash advances available to member S&Ls for targeted public purpose lending. The rates were set at 50 basis points below the cost of funds to the FHLB making the advance.[13] The advance proceeds were relent by the member S&L for a variety of purposes, including single and multi-family mortgage loans. Between 1978 and 1983, $9.7 billion was lent for these purposes.[14]

Unfortunately, in 1983 the program became voluntary at each of the FHLBs. Those Banks that continued the program were free to set the interest rate on the targeted advance. Between 1983 and 1988, only $719.6 million in cash advances were made under the weakened program.

The FSLIC bill should reestablish this targeted cash advance program on a mandatory basis at each of the FHLBs. Like the original program, it should include a significant rate reduction. It should also cap the interest rate at which the advance proceeds can be relent for targeted lending.

THE FSLIC BILL SHOULD INCLUDE SUBSIDIES AND OTHER INCENTIVES FOR TARGETED LENDING

Aside from the discount available through the targeted cash advance program, S&Ls should be given additional incentives and resources to engage in public purpose lending to meet low-income housing needs. The FSLIC legislation should include two types of incentives: 1) federal subsidies made available by modifying existing housing subsidies and eliminating unnecessary S&L tax preferences and 2) a discounted insurance premium for lenders that participate in the targeted loan program.

We Should Look to the Mortgage Interest Deduction and the Tax Benefit Now Available to the Thrift Industry For The Subsidy Needed for Low-Income Lending

Under section 593 of the Tax Code, qualified S&Ls now get a bad loan deduction that is unavailable to other financial institutions, including banks. Such a tax benefit, which particularly benfits profitable institutions, cannot be justified unless it accrues only in proportion to a thrift's investment in mortgage-related assets that serve a public purpose that would not otherwise be served by the free market on its own. As we discussed earlier, mortgage lending, per se, does not serve this purpose. Instead, the existing benefit should accrue only to lenders engaged in targeted lending to low and moderate income homeowners and renters, and the benefit should take the form of a rate subsidy, rather than a tax shelter. Because this subsidy would only substitute for an existing tax benefit, it would be revenue neutral.

Another subsidy source that would be revenue neutral is the mortgage interest tax deduction, which is now available as a housing subsidy for vacation homes and million dollar estates. By reducing that housing subsidy in a way that would not affect middle-income or even uppper-middle income homeowners, we could transfer the housing subsidy available to the wealthiest to help meet the housing needs of the poorest.

For example, according to 1988 estimates from the Congressional Budget Office, we could raise about $10 billion in revenue over 5 years, or $2 billion each year, by capping the mortgage interest deduction at $20,000 per year on a joint return ($12,000 for a single person).[15] This would still allow full deductibility on a mortgage loan balance up to $200,000 ($120,000 for a single person).[16] In fact, CBO estimates that this option would affect less than one-half of one percent of all taxpayers.[17]

Alternatively, we could raise a significantly smaller amount by limiting deductions on debt to acquire second homes, most of which are vacation homes. Under one version of this option, we could require interest deductions for second homes to qualify under the current $100,000 interest limit on home equity loans secured by the primary residence. This would raise about $2 billion over 5 years.[18] Obviously, if the $100,000 ceiling for home equity loans were lowered, additional revenues could be raised.

The Insurance Premium Assessment Should Reward, and Involve the Entire Industry in Supporting, Public Purpose Lending

S&Ls should be encouraged to serve specialized lending needs with reduced insurance premium assessments. S&Ls that are not meeting these needs but are still getting the benefit of public insurance and access to favorably-priced FHLB cash advances should be required to offset the discount with increased premiums. This way, there is no risk to safety and soundness and the entire industry contributes, directly or indirectly, toward meeting the housing needs of low and moderate income consumers.

If the premium assessment included in the Administration's FSLIC proposal remains relatively high (.23/$100), the discount available to qualified lenders could be a total assessment waiver on deposit amounts equal to the targeted loan amounts. Again, lenders not engaged in targeted lending would pay higher assessments to off-set the discount.

PUBLIC DISCLOSURE AND PUBLIC PARTICIPATION ON THE BOARDS OF THE FHLBs ARE BASIC STEPS TOWARD PUBLIC ACCOUNTABILITY

Although the Bush proposal contemplates a massive public bailout of the thrift insurance fund, and increasing costs to both bank and thrift consumers, it totally ignores the need for public accountability in the future. The public that is footing the bailout bill has a right to know the types of activities in which publicly-insured institutions are engaged, and whether these institutions and their regulators are meeting their public responsibilities. Instead, the Bush proposal reserves the shroud of secrecy that has characterized the banking and S&L industries, and their regulators, for decades.

Few subjects of public disclosure are more important than the racial, gender, and income characteristics of an individual institution's borrowers. Recent studies have uncovered disturbing evidence that industry lending patterns exclude racial minorities, even when minority loan applicants exhibit the same credit worthiness as white applicants. Public disclosure of racial and gender lending patterns, along with information regarding the credit qualifications of successful and unsuccessful loan applicants, would help measure the extent of this problem within our publicly-insured lending institutions.

Public disclosure of agency-prepared Community Reinvestment Act assessments and ratings is also important for public accountability purposes. The CRA evaluation represents the regulator's overall assessment of an institution's effort to meet its public credit responsibilities. As such, it also reflects on the regulator's own commitment to encourage and direct the industry to fulfill these responsibilities. Without public disclosure, the intended beneficiaries of our system of publicly-insured institutions lose on both counts, and the cozy relationship between regulator and regulated continues.

Finally, full public representation on the Boards of the 12 FHLBs would ensure enhanced public accountability on issues concerning safety and soundness and public responsibility. However, under the Bush proposal, these Boards will continue to have significant S&L industry control. Under section 703 of the bill, three of each Board's 9 directors are chosen by the industry, and these 3 directors help appoint 3 additional directors who are supposed to represent the housing and financial service industries. Only one/third of each Board is chosen from the public, and even here the Bush proposal fails to ensure that the public representatives have no ties to the industry.

The FSLIC bill reported by this Committee should require each Board to consist of at least 6 public representatives out of 9 total. These representatives should not have any financial interest in the thrift industry and should not have been employed within the industry during the 3 years immediately preceding their tenure on the Board.

II. WHAT SAFETY AND SOUNDNESS RULES SHOULD BE ESTABLISHED TO PREVENT ANOTHER HUGE BAILOUT IN THE FUTURE?

CONGRESS SHOULD REQUIRE THE FHLBB TO FOLLOW AN EARLY-CLOSURE RULE

As we have learned the hard way, forebearance is a costly regulatory principle. Had Congress required the FHLBB to intervene in closing the hundreds of insolvent or near insolvent thrifts in existence in 1986, for example, the bailout costs facing us would be a fraction of what they are today.

We applaud the Bush proposal for terminating today's statutory forebearance provisions. (Section 317) However, it fails to go far enough in repudiating forebearance as a regulatory principle.

First, it grandfathers existing capital plans previously approved under the forebearance provisions in current law. Second, it fails to require the FHLBB or other regulator to intervene to close or merge a weakened institution before it becomes insolvent and poses a liability on the federal insurance fund. We believe that such an early intervention rule should be at the core of safety and soundness reforms.

The bailout legislation should go beyond merely authorizing the regulatory agency to intervene to control an institution that is approaching a negative net worth situation. Our proposal is to require the agency to intervene, to put the institution in receivership, and to arrange a merger or liquidation. Only this type of approach will safeguard consumers and taxpayers against another multi-billion dollar insurance fund bailout in the future.

The FHLBB proposed an early intervention rule through an Advanced Notice of Proposed Rulemaking late last year. That proposal authorized the agency to intervene when a thrift's core equity capital dropped to 2.0% of assets. It authorized the agency to close or merge the institution when its core equity capital dropped to 1.5% of assets.

We believe that the agency was on the right track in proposing this early intervention scheme. Congress should simply hold the agency to its own good intentions by requiring it to intervene according to the same schedule of declining net worth position. Congress should also clarify that the mandatory regulatory intervention should be triggered on the basis of market value net worth, rather than book value net worth. Otherwise the insurance fund will be at risk because GAAP net worth can be significantly higher than actual market value.

The Bush proposal appears to rely on the FDIC's authority to terminate insurance under section 8(a) of the Federal Deposit Insurance Act (FDIA) (12 U.S.C. section 1818(a)) to protect the deposit insurance fund. Unfortunately, termination of insurance is such a draconian measure that it will be used only very sparingly, and after the institution has already reached, or come perilously close to, a negative net worth position. Indeed, the FDIC has current authority to terminate insurance if it determines that an institution is in an unsafe or unsound condition, but it has only invoked that authority one time.[19]

Finally, when a regulator closes an institution by appointing a conservator or receiver, the regulator should be given tools to settle creditor claims through an administrative law process including arbitration, rather than in the courts through protracted litigation. Section 211 of the bill take some steps in this direction.

Streamlining the procedure would enhance the regulator's ability to act promptly to close an institution because it would reduce the agency resources necessary to resolve the case. Waiving the right to engage in protracted litigation, for example, challenging the appointment of a conservator, should be a condition imposed in return for federal insurance. If thrift shareholders do not like such terms and conditions, they are free to invest in mortgage banks, investment banks, or other kinds of financial institutions that do not have a claim on federal taxpayers.

In sum, as the FHLBB has already indicated in its advance notice of proposed rulemaking, early intervention to merge or close a thrift before it is insolvent is a crucial ingredient in protecting the insurance fund and taxpayers. Regulatory intervention in the form of growth restrictions, supervisory agreements and enhanced oversight should begin when the institution falls below minimum capital requirements. Intervention in the form of a receivership and subsequent merger or liquidation should automatically occur when the institution's capital level sinks to 1.5% of the market value of assets. The FDIC's insurance revocation power should automatically come into play when the institution is insolvent. We will not overcome the regulatory tendency toward forebearance unless these clear and automatic intervention requirements are set forth in law.

SUPERVISION AND OVERSIGHT OF THRIFT INSTITUTIONS MUST BE TAKEN AWAY FROM THE FHLBs AND PLACED IN A FEDERAL GOVERNMENT AGENCY COMPLETELY CONTROLLED BY THE FEDERAL GOVERNMENT

Supervision of safety and soundness of thrift institutions today is directed by the FSLIC Office of Regulatory Affairs in Washington, but it is implemented by examiners and supervisory and enforcement staff employed by the 12 FHLBs. The Banks, in turn, are owned by the regulated industry. This arrangement began in the mid-1980's to avoid personnel and budget limitations imposed by the Reagan Administration, and it is continued in the Bush proposal.(See section 702(c) of the bill.)

This regulatory scheme is fraught with danger. The FHLBs are owned by the very institutions they are supposed to supervise. Although every effort should be made to ensure that each Board of Directors will be independent of the thrift institutions that own the Bank, we are not likely to succeed

100% in this effort. Fair enforcement and protection of the federal taxpayer require that Congress return to a federally-paid and managed supervisory and enforcement staff completely independent of the supervised thrift industry. The changes in industry control of the FHLBs in section 703 of the bill are better than today's state of affairs, but do not adequately solve this problem.

Yesterday's Wall Street Journal provides a good example of how the FHLBs can scew data to serve the interests of its member institutions. According to that newspaper, the Topeka FHLB estimated losses at the failed Silverado Banking Savings and Loan Association of Colorado at $200 million. They are actually $1.2 billion. It quotes FHLBB member Roger Martin as reporting, "The Dallas bank told us there were only 87 insolvent institutions in that district in late 1987; now there are 211."[20]

Similarly, the FHLBs can have a conflict of interest between their function of providing credit advances to member thrift institutions and their responsibility as regulators. For example, on December 16, 1988, the FHLB of Indianapolis sent letters to its member thrift institutions in Indiana and Michigan offering to provide them short-term advances as "window dressing" that would improve their official financial reports.[21]

Preserving the status quo at the FHLBs with minor tinkering will eventually cause another breakdown in effective federal oversight and thrift safety and soundness. The authority of the FHLBs chairman to remove FHLB employees (section 702(d) of the bill) does not solve the basic problem of distorted incentives. Thrift supervisory responsibility should now be placed in a completely federal institution responsive and responsible only to the federal government.

Congress should also exempt this federal agency from civil service salary ceilings and other traditional federal controls to ensure adequate salaries, examination staff, and other resources. Congress has already exempted the FDIC from some personnel requirements so that it can pay the salaries necessary to attract and retain skilled examiners, attorneys, and financial experts. We agree with the GAO's position that "the regualtory and examination functions of the new FSLIC should be exempted from the federal personnel ceiling and salary limitations just as they are for FDIC." [22]

III. WHO WILL PAY TO SHORE UP BOTH FSLIC AND THE FDIC IN THE MOST PROGRESSIVE MANNER POSSIBLE, AND HOW WILL INCREASED INSURANCE PREMIUMS AFFECT THE AVERAGE DEPOSITOR?

THE PRINCIPLES OF PROGRESSIVITY AND PRUDENCE SHOULD DETERMINE OUR RESPONSE TO THESE QUESTIONS

We wholeheartedly support the Administration's proposal to beef up our criminal and civil enforcement capacity to hold those responsible for the huge waste of publicly-insured funds accountable for their misdeeds. Unfortunately, it is clear that any sums we recover in restitution will come too late and in insufficient amounts to meet our enormous needs.

Even relying on the optimistic assumptions underlying the Administration's cash flow projections, the Administration's proposal will require $28.1 billion in federal outlays between 1989 and 1994.[23] If we eliminate increased S&L premiums as a supplemental revenue raising mechanism, as we propose, the budgetary impact over the same period will total approximately $43.7 billion.[24] Even this figure is unrealistically low because of the low interest rate assumptions on which it relies.[25]

Now that we are all used to dealing in tens of billions of dollars, the enormous budgetary impact of these FSLIC demands alone may not be fully appreciated. To get a better handle on how this huge sum of money may affect important social programs, compare $43.7 billion to the estimated fiscal year 1989 budget authority for all HUD-assisted housing programs -- a meager $7.2 billion.

From a public policy perspective, there is one overriding principle that should govern our search for a "quick" source of revenue to finance these extraordinary costs -- that principle is progressivity. We should not disproportionately burden those segments of society least able to contribute toward such a huge public demand for funds. This means we should look to our wealthier citizens to contribute most heavily. It also means we should not indirectly burden our least wealthy citizens by dipping into federal social programs that help them meet the basic necessities of life.

Another important principle is prudence. If we are going to borrow to raise the needed funds, we should select the cheapest credit terms that are practically feasible. The public does not deserve spendthrifts in Washington.

THE BUSH PROPOSAL IS NOT PROGRESSIVE

Unfortunately the Bush proposal ignores the principle of progressivity in two ways: First, it relies heavily on an increased deposit insurance premium, which, at best, will be passed through proportionately, rather than progressively, to all bank and S & L customers. More likely, it will be passed through in a way that disproportionately burdens low and moderate income consumers.

Second, it also relies heavily on federal treasury contributions to meet the interest and other direct and indirect costs of the bailout. In these days of tight federal budgets, such extraordinary federal outlays must have an extraordinary revenue stream to support them. Otherwise, we will face two unacceptable choices: an increased budget deficit or budgetary cuts in programs for the most needy. Aside from the regressive industry premium increase, the Bush proposal does not identify any new revenue stream to support these extraordinary costs.

THE BUSH PROPOSAL IS NOT PRUDENT

The Bush proposal also scores poorly in terms of fiscal prudence. It raises $50 billion in an off-budget agency that can only raise funds at prices that are at least 25 basis points more than what the federal government would pay if it raised the funds directly. If we are going to go "off-budget," we might as well take this step in the cheapest way possible by allowing Treasury to issue the bonds directly and declare the borrowing to be "off budget."

Second, the bonds issued under the Bush proposal will extend for 30 years, rather than a shorter time period that would reduce their financing costs. The Administration's rosey assumptions about future interest rates would suggest that the 30 year interest costs on these bonds will total $100 billion.[26] Using more realistic assumptions, the Chairman of the House Banking Committee has estimated that the interest costs on the bonds will cost $150 billion.[27]

INCREASED PREMIUMS ARE A HIGHLY REGRESSIVE REVENUE RAISING APPROACH

Several weeks ago, the Administration's "trial balloon" user fee proposal was immediately shot down as a regressive and unfair tax on innocent consumers. The increased premium proposal is the same type of regressive tax, but it is disguised in sheep's clothing.

Under the Administration's proposal, the S & L industry's 1990 increased premium contribution to FSLIC for the bailout will total $2.3 billion, an amount that is expected to increase each year. We anticipate that the industry will pass through most of these increased costs to their customers, rather than their shareholders.

This conclusion is based on two considerations: First, more than half of the S & L industry is composed of institutions organized in the mutual form -- these institutions could not pass through the added costs to shareholders. Second, although the balance of the industry could theoretically pass through their costs to shareholders, most of the industry will be hard-pressed to take the increased costs from retained earnings and still meet the substantially increased capital requirements that any bailout legislation should contain.

The regressive impact this premium pass-through will have is evident from statistics on 1) industry pricing patterns since interest ceilings on deposits were lifted and 2) the demographics of bank and S&L accountholders. Using these statistics, the Consumer Federation of America has prepared an incidence analysis, which compares the relative burden born by various income groups under a premium revenue raising mechanism versus the current federal income tax system. On the assumption that the industry will distribute the increased costs among accountholders in a way that follows historical pricing patterns, their analysis indicates that the increased premium will be exceptionally regressive.

The current regressivity of deposit account pricing structures is also reflected in analyses prepared in 1985 by my organization, which shows that consumers with lower balances ($500) bear a higher percentage of industry costs in the deposit account price structure than consumers with higher balances.[28]

Although we derive some emotional satisfaction in saying, "Let the industry pay," that is unfortunately a simplistic formula that only hurts those least able to pay. The Administration was accurate a few weeks ago in calling this revenue raising scheme a user fee, and the critics of the user fee proposal were correct in rejecting it as unfair and regressive. We urge Congress to face this reality squarely, and, in resolving today's problems, to look to alternative fundraising mechanisms that do not involve a premium increase.

CONGRESS SHOULD CHOOSE FROM A VARIETY OF PROGRESSIVE FUND RAISING OPTIONS

There are several ways to raise additional income to meet the extraordinary costs of the FSLIC bailout without affecting important social programs or increasing the federal deficit. We recommend that Congress seriously consider all options.

In particular, we have urged the House Ways and Means Committee in written and oral testimony, and will also urge the Senate Finance Committee, to consider the merits, relative to other alternatives, of increasing the tax rate paid by those in the highest income bracket to at least equal the tax rate paid by those in the second highest bracket. Single taxpayers earning between $44,950 and $104,510 pay at a marginal tax rate of 33%, while those earning over $104,510 only pay at a marginal rate of 28%. We hope this Committee will seriously consider this and other options also.

This option would not only eliminate a serious glitch in the progressivity that otherwise governs the tax code. According to estimates provided in 1988 by the Congressional Budget Office, it would also raise about $30 billion over a 5 year time period.[29] This alternative, and others that should be explored, could fund a large part of the bailout -- progressively.

CONGRESS SHOULD INSULATE BASIC DEPOSIT ACCOUNTS FROM BEARING A DISPROPORTIONATE SHARE OF THE INCREASED INSURANCE PREMIUM COSTS

If the FSLIC bill reported out of this Committee preserves the Administration's proposal to increase industry insurance premiums, the bill must also ensure that low and moderate income consumers do not bear the brunt of these increased costs. The $2.3 billion cost increase for S&Ls, and the even larger increase for commercial banks, should not translate into skyrocketing service fees for low-balance accountholders, and business as usual for high-balance accountholders.

FOOTNOTES

1. Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the State of New York to provide information, education and counsel about consumer goods and services and the management of family income. Consumers Union's income is derived solely from the sale of Consumer Reports, its other publications and films. Expenses of nonrestrictive, noncommercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, Consumer Reports, with approximately 3.5 million paid circulation, regularly carries articles on health, product safety, marketplace economics, and legislative, judicial, and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

2. Brunbaugh, R. Dan, Thrifts Under Siege (Ballinger Publishing Co. 1988) at 17.

3. GAO, Thrift Industry: Trends in Industry Performance: December 1977 Through June 1987, (May 1988) at 23.

4. Id.

5. Id.

6. Id.

7. Brumbaugh (note 2, supra), at 164.

8. HUD, Office of Financial Management, "Annual Gross Flows of Long-Term Mortgage Loans on 1-4 Family Non-Farm Homes."

9. Id.

10. FHLBB, Industry Data and Reports Division, "Terms on Conventional Home Mortgages: National Averages by Type of Lender and Loan."

11. 1988 Report of the National Housing Task Force.

12. FHLBs, Office of Finance, Financial Profile (Sept. 30, 1988).

13. Conversation with Peggy Spohn, FHLBB, March 10, 1989.

14. Id.

15. CBO, Reducing the Deficit: Spending and Revenue Options: A Report to the Senate and House Committees on the Budget," Part II at 320.

16. Assuming an average mortgage interest rate of 10%.

17. CBO report (note 15, supra).

18. CBO report (note 15, supra) at 321.

19. Conversation with ORA/FHLBB officials, March 6, 1989.

20. Wall Street Journal, Tues., March 14, 1989 at A26.

21. "Regulator Offers to Help Dress up S&L Report," American Banker, Jan. 6, 1989.

22. Testimony of Frederick Wolf before the House Banking Committee, Jan. 13, 1989.

23. Appendix to Testimony of Treasury Secretary Nicholas Brady before the Senate Banking Committee, Feb. 22, 1989.

24. The Administration estimates that the increased S&L premium will raise $15.6 billion between 1989-94. The $43.7 figure is derived by adding $15.6 and $28.1.

25. The Appendix to Secretary Brady's February 22 testimony (see note 23, supra) indicates that the Administration's estimates assume the REFCORP bonds will have a 7.9% interest rate in FY 1990, and a 6.5% interest rate in FY 1991.

26. At the time this testimony was prepared, the Administration has only publicly released cost projections through 1999. This 30-year cost estimate was derived using its 89-99 weighted average interest rate assumptions.

27. See, "Making the Bailout Workable: An Analysis of the Administration's Plan to Resolve the Thrift Crisis," Feb. 22, 1989.

28. See, Consumer Reports, Sept., 1985 at 513.

29. CBO, Reducing the Deficit: Spending and Revenue Options: A Report to the Senate and House Committees on the Budget, Part II at 287.

The **Chairman**. Very good.

Miss Miller, before we start with you, we've had a number of other colleagues come in. Senator Graham has come in and Senator Garn and Senator D'Amato. I'm wondering if any of the three of you wanted to make an opening comment before we hear from Miss Miller.

Senator **Graham**. Mr. Chairman, thank you. I have no opening statement.

The **Chairman**. Senator D'Amato.

Senator **D'Amato**. Well, Mr. Chairman, I have a statement which I'm going to ask be submitted in the record as if read in its entirety. I'm not going to be able to stay.

The **Chairman**. Without objection.

Senator **D'Amato**. I'd like to make just this point, that the one part of the bill that disturbs me and I know a lot of my other colleagues is that which deals with the credit unions. The credit unions are not for profit and are well-managed. They have a 1.3 reserve against deposits. They don't belong in this package. They are not broken. Don't try to fix them. And I would hope that we could develop a consensus. I certainly will move by way of amendment to delete them from this bill.

If the other insurance funds had nearly the kind of solvency that they do, we wouldn't have a problem. So I have a fuller text on this and I'll ask that that be submitted.

[The complete prepared statement of Senator D'Amato follows:]

OPENING STATEMENT OF SENATOR D'AMATO

Senator **D'Amato**. Mr. Chairman, I am pleased that today's panels will give us the perspective of the depositors, the consumers and the credit union movement. We must bear in mind that while banking legislation often resembles a sort of battle of the Titans, that the daily lives of many people are affected by our decisions. In S. 413, which I support in general, we have an example of a sort of legislative afterthought that is unwise, unnecessary, and detrimental to the lives of millions of working people. I am referring to the inclusion of the credit union fund in this FSLIC deficit plan.

I have said before that I am puzzled as to how this matter came to be in this bill. However, on reflection, it is not so dissimilar from other odd ideas that turn up from time to time in a comprehensive piece of legislation. So I now understand how this came to be. But make no mistake. The credit union fund, with its 1.3 percent of reserve against deposits, does not belong in a package that deals with undercapitalized insurance funds. This is a bill to deal with things that need mending. As to the National Credit Union Insurance Fund: If it is not malfunctioning, do not endeavor to repair it.

Credit unions are very conservative, member-owned, nonprofit institutions. The Credit Union Insurance Fund is not now and has never been insolvent, nor does it present a current risk to the Federal Treasury. Yet, this bill would restructure the NCUIF in ways that would actually weaken it. Under this plan, the superior self-insurance aspects of the credit union movement would be replaced by yet another Government-controlled fund. Furthermore, for less protection, the credit unions would actually be required to pay more.

As I have suggested before, if it is important to make all the deposit insurance funds look the same, we would do better to use the credit union's for a model. For this reason, inclusion of the NCUIF in this plan is improper. And I intend to offer an amendment to remedy this situation.

Thank you, Mr. Chairman.

The **Chairman**. Senator Garn.

Senator **Garn**. Mr. Chairman, I have no opening statement. I apologize for being late, but as usual there are conflicting committee meetings and I simply had to be at another meeting until this time. But I have no opening statement.

The **Chairman**. Thank you.

Miss Miller, do you want to introduce the person who accompanies you?

Miss **Miller**. Yes, I will.

STATEMENT OF PEGGY MILLER, LEGISLATIVE REPRESENTATIVE, CONSUMER FEDERATION OF AMERICA; ACCOMPANIED BY MARK COOPER, RESEARCH DIRECTOR

Miss **Miller**. I am Peggy Miller of the Consumer Federation of America. With me is Dr. Mark Cooper, our research director.

CFA is an organization representing over 240 organizations that are national, State and local, who in turn represent 50 million Americans.

This is a difficult subject. I am pleased to be here today and to have the chance to take our position and bring it to the committee, but it's a very difficult problem. To begin with, I want to try to express or carry to the committee—I realize that you are receiving calls constantly from your constituents, so you are probably aware of the public concern on this issue.

Our membership has been more active probably than ever before and it predominantly—the thing that I'm most concerned about is the development of extreme distrust and extreme lack of confidence. There's this belief by many of our members and we see it throughout the public at large that even if laws were to pass they wouldn't necessarily be implemented.

And I can't say that I blame them because the record that's been brought out on this crisis is in the early years particularly that even up to the higher levels of the administration in the earlier years there was just a turning away from the responsibility and a turning away from compliance with the law.

There's a conflict of interest problem here that has been revealed that is extremely problematic. Because of that, the first point that I want to hit on that I think is of real importance, in addition to the other reform issues that are needed in the bill, is that basically this concern—this lack of trust—needs to be addressed.

The only way that we think you can really address that problem is to incorporating, by having more representation within the system. What we recommend is that the Bush plan change the Federal Home Loan Bank System. They cut down the S&L participation. We support that. We think that is definitely helpful. We might have carried it even a bit further.

But in addition, we would recommend that you have consumer representation—explicit consumer representation on those bank boards. They can participate in this system. They can be informed representatives that can help make this system work a little better.

In addition, the point that we are making on disclosure is that many consumers—the public at large feel they can't even get the information to find out in the future are your laws being implemented. If you make changes in terms of housing loans, will they be implemented?

And one of the ways that they ask is simply that they get the information through clear disclosure at the local level. We think that's a small thing to include. That's accountability and responsibility.

In addition, we think on the bailout that basically what the plan has is, by raising the insurance fees, our problem is—and Dr. Cooper did an incidence analysis and he will answer any questions that you have—of a study where we tried to check the pass-through argument. We went back and tabulated what has happened in the past. Our concern is, if these fee increases go through, that basically you will have 36 percent, if history continues, of them borne by those under $25,000 income.

This is absolutely unjustifiable because these people—we also show—have a net cost to checking over the last few years. They didn't even have a net yield. So that they didn't even benefit from higher interest rates.

We recommend a tax approach, a specific tax approach, over a 5-year period of time. We feel that that's more economical and more equitable. We would support it going on the upper income in this situation.

But if the committee fails to address that and you keep the insurance fee increases in it, we ask that you at least incorporate into this a small insulation device for the lowest income. Basically because of pass-through, what happens if the high income do not have fees tacked on. It's a competitive situation. We understand that from that standpoint. But at the same time, the very lowest income, we're very concerned over this trend of dropping out of the banking system. We think for economic reasons and for overall system reasons, it's better to keep them in and we ask that that would be included if the fee increases remain in.

On the housing position, we look at that from two standpoints. We do support a redefinition and a strengthening of the housing function of the thrifts. We see that you can do that in a number of ways.

You can do it through the QTL tests. There, what we would recommend is that you also target them so that the QTL there's language in it that deals with low and moderate income and first-time home buyers because there needs to be a sensitivity.

There has been a development over the last few years that shows that when you work with low income specifically through things like limited equity arrangements, you truly can through a loan position deal with their problems of housing plus maintain a safety and soundness position.

We would recommend attacking it from that standpoint, as well as the cash advance system that's already been brought up.

We also think you can strengthen—the Bush plan dealt some with high risk. We think we carried it a step further and say, to in a sense impact lending patterns but for safety and soundness purposes you can deal with direct investment in brokered deposits and get them out. We do not feel they have a place in a publicly insured institution whatsoever. We would carry that throughout the system.

Those can be in the free marketplace, in our opinion. That would free up more loans for housing and community reinvestment and then, by targeting them, you would basically be covering it from two angles that we support.

We also support—there has been an idea that wasn't even—they requested to testify today. They are not here. I do want to point out that there is an idea that a number of groups have been working very strongly on and it has to do with spreading the raising of funds for housing through the entire financial structure. You could do this in a number of ways. They are suggesting you do it by actually taking a small part of the investment portfolios of all financial structures, putting it into a housing fund, and moving it into housing.

These are the kind of things you could do to tackle the housing function.

Finally, from the standpoint of safety and soundness or what we call agency reform, there are many provisions in the Bush plan we do support. They did take a stronger position in terms of accounting principles and capitalization and stronger salaries. We support all of those functions. But we do have a real concern and the concern has to do—and it ties in in two ways.

The more specific way it ties in is from the standpoint of the early intervention question. Basically, the way we interpret from a consumers' standpoint the way the plan has been drafted is that it would use insurance—the FDIC—as the sledge hammer. That's their way that they chose to tackle the problem of restraining insolvency problems. It's not that we disagree with sledge hammers. We think they are necessary in this. And it's not that we disagree with using insurance more forcefully for this purpose. But consistent with the argument that you separate the Federal Home Loan Bank functions, the regulatory functions from the FSLIC functions, that argument in our position, to avoid all conflict of interest and confusion, should be carried through the entire system.

What would that mean? What that means is that the regulators should play a more forceful position, that what we've had here is a problem where, yes, they did not do so. We can point fingers as to all the reasons why. But to take that away we do not support that as a final structure. Where this has the most impact from a purely confusing and a product standpoint is the way they drafted using insurance there would be extreme confusion, in our opinion, on the part of the consumer. All we can interpret is, if suddenly the safety and soundness was being questioned and the insurance was removed, you get a notice in the mail or something saying you had 6 months to pull out your deposits. Well, what if 3 months later safety and soundness has been restored? You get another notice saying, OK, it's all right now. What we think from the way that was drafted and we think the intent was good, but the result would be strong confusion so that what would finally happen is that you would erode the understanding of the seal.

The seal in the public's eye and the name of the institutions are very linked. You don't necessarily always look for the seal on the door. So what we would recommend to avoid this kind of confusion and erosion is you use the regulator in a very strong fashion, that basically on a three-tier approach you move them in from a safety and soundness standpoint wherever problems are detected, and they work with the institution. At the point that the asset base drops to 2 percent, at that point, you then force a merger or sale. So that you never reach a point of complete insolvency.

If that does not work, then you move in the insurance device as a final hammer and at that point the institution is closed. We think this would avoid confusion. We carry that through the whole structure in terms of the separation of the insurance and the regulatory functions.

We think a plank of this nature and on the final point—and I know I'm taking too long—is we are absolutely opposed to the asset requirement for the credit unions.

The reason we are opposed to it, more than any other reason, is because in our interpretation who it would impact is the small credit unions. They are the ones who would be most severely impacted and they are the ones who the whole structure has been set up for. We ask the committee if they have concerns over some of what's happening within the credit union industry, fine. We will work with you. But we are here to support a small credit union function that's nonprofit. Sometimes it's the only avenue that low income or minorities have in terms of having some sort of financial structure, and we really see this as a problem.

So basically, across the plank, we think with inclusion of those points throughout you would have a good bill.

[The complete prepared statement of Peggy Miller follows:]

Consumer Federation of America

TESTIMONY

of
Peggy Miller
Consumer Federation of America

Before the

Senate Banking, Housing, and Urban Affairs Committee

on

THE SAVINGS AND LOAN CRISIS

MARCH 15, 1989

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121

Mr. Chairman, Members of the Committee, I am Peggy Miller of the Consumer Federation of America, (CFA). CFA is a non-profit organization comprised of over 240 national, state and local organizations representing more than 50 million consumers in this country. With me today is Dr. Mark Cooper, our research director.

We come here today to speak about the Savings and Loan crisis. The Committee advised us that the legislative vehicle before the Committee for consideration is the proposed Bush Plan, otherwise entitled the Financial Institutions Reform, Recovery and Enforcement Act of 1989. In the interests of working toward a rapid conclusion of this financial crisis we have come prepared to work from that vehicle.

We come representing everyday consumers, who put their funds into this system, who are a silent partner of this system, and who now realize that this silence has cost them dearly. The squandering of hundreds of billions of public dollars which they have witnessed threatens to destroy their confidence in the government's ability to create and maintain a safe and sound banking system. Consumers' feelings of helpless rage continue unabated, as I am sure you are aware. Though we realize that you must work with speed, and we are ready to work with you, we must all be careful to include reforms within an amended Bush Plan that will help restore public trust.

The legislative provisions which would accomplish this goal are:

1) assurance of public accountability through the systematic incorporation of consumer representatives into the regulatory process through adequate representation on the Federal Home Loan Bank Boards and the establishment of regulatory consumer divisions, as well as clear, public disclosure of lending practices, services and exam results;
2) the overall strengthening of the public purpose of the thrift industry so that housing and community lending are clearly targeted and encouraged for safety and soundness as well as public need purposes;
3) the ability for early intervention and strong management enforcement by the regulators to avoid further insolvencies;
4) the protection of the poor from additional fee premium increases through basic banking; and
5) the use of the tax system as a more equitable and economical bailout mechanism.

ACCOUNTABILITY AND RESPONSIBILITY:

The improvements in capitalization, accounting and supervision requirements found in the Bush Plan will help tighten the thrift system and bring it back to fiscal soundness. We commend President Bush and the Treasury Department for their rapid presentation of legislation that addresses these areas of concern with strong reforms.

However, the extent of the criminal misconduct within the Savings and Loan industry and degree of public and private management laxity that were exhibited border on total disregard for the law. The facts surrounding today's S&L crisis indicate that the top Reagan Administration regulators were part of the problem. What we have here is conflict of interest, or such a strong appearance of conflict that all legal and ethical divisions established to safeguard against such conflict have been circumvented. Therefore, even though new supervision requirements and stronger financial safety nets are needed, and we support them, they must be accompanied by measures that provide maximum protection against future mismanagement.

To help ensure that such follow-through occurs immediately, and continues through the years, consumer representatives must be systematically incorporated into the process through adequate representation on the Federal Home Loan Bank Boards, and through establishment of regulatory consumer divisions at all appropriate levels of the process. The Bush Plan calls for reforms in the make up of the FHL Bank Boards. We ask that those positions, which total nine slots, include two consumer representatives.

Furthermore, to ensure future ability of all consumers to effectively monitor the implementation of reforms, there must be full and clear public disclosure of all lending practices and services, and the beneficiaries of loans by race, income, and geographic area. The language proposed in the Fair Lending Oversight and Enforcement Act of 1989, as well as the language on lending disclosure passed in H.R. 5094 last year address these disclosure needs.

Such legislation would ensure that the consumer could obtain information necessary to know if the thrift institutions, or any other publicly insured institution of concern was carrying out the law in terms of safety and soundness, as well as investment restrictions.

BAILOUT PLAN:

The provisions for funding the bailout in the Bush Plan would be borne most heavily by low and moderate income consumers because higher bank premiums would most likely be passed through to consumers who hold small accounts. Such an outcome, when these same individuals have borne a net cost in their checking accounts during these years of high-risk, speculative investment practices adds insult to injury.

We have attached a copy of a recent analysis that CFA conducted which demonstrates that if a pass through of increased fees were to follow recent patterns of checking account fee increases, it would impose a heavy burden on households under $25,000 annual income levels. It shows through incidence analysis that 36 percent of the fee burden has been passed on to those with under $25,000 annual income. It also clarifies that an income tax approach is far more equitable for purposes of raising capital to pay for the bailout since these same consumers would shoulder only 6 percent of the tax burden.

We further conclude, based on analytical results showing that these same low income consumers have had a net loss in their checking account costs due to bank fee increases, while upper income have experienced a net gain, that the bailout costs should be predominantly shouldered by upper income households.

(The regulators should have the flexibility to raise premium fees in the future for purposes of keeping the insurance funds solvent in the future. We are concerned over future FDIC insolvencies and realize that increases in premium fees might be necessary to strengthen that fund. Still, in this event, a basic banking package would be necessary to insulate the low income households.)

Furthermore, we agree with those, such as Chairman Gonzalez of the House Banking Committee, that the long-term bond structure of the Bush bail out plan is unnecessarily costly. Once again we point out that the tax approach is more economical, equitable and efficient.

Dr. Mark Cooper conducted this incidence analysis and is here to respond to any questions the Committee might have.

Let me reiterate my remarks on the bailout issue with this clear statement: if the provisions to increase the premium fees remain in the Committee's bill a basic banking package must be added. In addition to our study mentioned above which documents how, if financial institutions follow the same course as they have in recent years, the poorest Americans with the least assets, will be forced to bear the inordinate share of the S&L bailout cost, let me point out that we have all seen the increase in check cashing outlets in the last five years. The GAO study on check cashing pointed out that nearly 20 percent of the families in this country no longer are participants in our banking system. CFA has clarified the extortion of those who are forced to rely on these check cashing outlets, who often face charges of 6 percent of the face value of the check, with as high a charge as 30 percent having been reported. Further bank fee increases for these low-income customers, who have benefitted the least from recent reductions in banking regulation, will greatly aggravate this situation.

A basic banking package would provide a small source of insulation for the lowest income through lifeline accounts and check cashing privileges. We would prefer that the Committee work with the Finance Committee and pay for the bailout through a specific tax, but if that is not "in the cards", we underline that some insulation must be offered.

THRIFT LENDING:

A clarification of the public purpose and the powers of publicly-insured institutions is needed. The risk borne by the public in the solvency of these institutions underscores the need to look carefully at the broad powers currently allowed thrifts and banks. In relation to the thrifts, we believe that the Bush Plan takes a fairly strong position against a high risk position, but that it does not go far enough. CFA supports the elimination of direct investments, particularly real estate equity and junk bonds, as well the use of brokered deposits, and the refinement of the S&L lending programs by targeting mortgage and community investment lending as the main, critical requirement. We support the broadening of the Qualified Thrift Lending test to include banks that qualify under current levels, with a sharpening of the language targeting programs for low and moderate income housing.

Thrifts were established for purposes of home mortgage lending. That purpose should be supported, but reaffirmed and sensitized so it addresses the different housing needs of low income, moderate income and first-time home buyers. The superior performance of S&Ls that stayed closer to the mortgage origination function, as well as the strong need for residential mortgages in this country support such a position.

High risk concerns vs. mortgage profitability:

The evidence shows that mortgage lending, and even mortgage origination, can improve the overall safety and soundness position of a publicly-insured financial institution. We recognize that an excessively high level of fixed term loans can be restrictive and lead to a degree of capital loss, as occurred in the late seventies and early eighties, but a reasonable level of ARM's as well as diversification in community lending can spread this risk sufficiently.

On the other hand, diversification away from mortgage lending has not shown itself to be excessively profitable. In fact, based on GAO statistics and other reports, CFA questions the risk of diversification for publicly-insured institutions where risk is held by the public at large.

A report prepared in 1984 by McKinsey and Company for the Comptroller of the Currency entitled "Financial Service Deregulation - Impact and Implications" questioned the profitability of diversification away from mortgage lending:

> "We have examined the potential earnings from discount brokerage, real estate brokerage, and insurance brokerage, and we concluded that while individual institutions might gain from adding these lines of business, the aggregate potential of the new products is too small to fully offset the reduction in retail banking revenues resulting from deposit deregulation and new forms of competition... competition for these products and the likely tenacious defense by existing providers of these services will limit the profits available to banks."

This same report also stated that even during the last years of Reg Q, when there was loss based on mortgage lending due to the interest rate spread:

> "The other principal component of bank retail profitability, apart from the spread, was the high return to mortgage lending."

GAO's study, THRIFT INDUSTRY, Trends in Thrift Industry Performance: December 1977-June 1987, shows the asset composition of all FSLIC-Insured Institutions by Net worth Category. It clearly outlines the high level of non-mortgage assets held by insolvent thrifts, 40.01 percent of assets, compared to that of solvent thrifts, 29.01 percent. Of additional interest is the table showing that of these non-mortgage assets, the insolvent thrifts held more than twice the level of direct investment assets, (including real estate and junk bonds) 5.57 compared to 2.04 percent of assets for solvent thrifts. Also, insolvent thrifts were shown to use brokered deposits as a means of growth in a more volatile manner than solvent thrifts, with an extremely sharp increase registered from 1985 to 1987.

Further substantiation of the strong correlation between the expansion into high risk, non-mortgage lending and risk of insolvency is found in the statistics of Ferguson and Company included in an analysis prepared by the office of Congressman Charles Schumer. It shows that the non-traditional investments as percentage of assets held by GAAP insolvent thrifts in 1987 was 12.2 percent, compared to the 8.1 percent of such non-traditional assets held by GAAP solvent thrifts in 1987. The greatest share by far, three times the level as held by thrifts in other districts, of these non-traditional assets was shown to be held by the Dallas Home Loan Bank District, the district which has been the focal point of the thrift failures.

CFA is not saying that these were the cause of the insolvencies; only that the ability to swiftly turn to such high risk investment areas, when solvency is threatened, along with the use of other practices intended to delude the regulators, including capital forbearance and net worth certificates, exacerbates a difficult problem. Furthermore, the high level of retained mortgage lending assets by the solvent thrifts documents the prudence of mortgage lending on a basis of safety and soundness as well as public interest.

Recommendations for mortgage lending reform:

There are many ways that the Committee could accomplish the goals of increased targeted mortgage lending:

1) Targeting Cash Advances: Linking the cash advance system to the provision of low-income and first-time home buyer loans is a concept that we support. We recommend that the cash advance system be tied to such home mortgages and offered to qualifying banks, as well as thrifts, who are willing to use the funds for such purposes. I understand that the Bush Plan has already supported the broadening of the cash advance system to all insured institutions. If so, we commend the authors for that, and only add that the cash advance system should be directly connected to the provision of low and moderate-income loans, including limited equity arrangements.

I know that I need not remind the Committee of the shocking reports on the racial and income discriminatory lending practices by the thrifts. (We do not ascribe such behavior only to thrifts, but they were the only institution willing to gather such information to begin with. We suspect similar practices in banks due to comparable case citations by consumers regarding the practices of banks.) Tying the cash advance program to loans for low-income and first-time home buyers will also help ensure the future avoidance of such practices, especially if accompanied by strengthened disclosure laws.

2) Mortgage Interest Deduction Limitation: We support limiting the mortgage interest deduction to $20,000 annual interest for joint returns,(approximately a $200,000 home) and $12,000 for single returns for purposes of using the resulting funds, which CBO estimates as being about $10 billion over five years, tied to the cash advance program, to subsidize the lower interest loans to low-income being targeted in the cash advance program recommended above.

3) Housing Fund: We support the concept of the establishment of a Fund to be capitalized by the entire financial services industry to supply low cost financing for first-time homebuyers and low and moderate-income housing development. The funds would be raised through a system that collects a small percentage of the investment portfolios of all financial service industry participants as certificates of deposits earning below market rate levels and then redistributed through qualified financial mechanisms as low and moderate-income housing loans.

AGENCY REFORM:

There are many portions of the Bush Plan that CFA supports, in whole or in part. I will enumerate on those first.

We support:

--- A strong separation of the insurance function from the regulatory function, namely the separation of FSLIC from the FHLBB. (On this note, the Bush Plan appears contradictory for it prescribes a strong level of regulatory powers over FHLBS by the FDIC, an insurance agency, instead of a continuation of such division of insurance and regulators at all levels of the financial system. We are concerned about this incongruity for we strongly support complete and consistent division of the insurance and regulatory function.

--- The shift to generally acceptable accounting practices (GAAP), though we recommend that the provision include language which allows for stronger accounting principles to be applied where deemed necessary by the FHLBS.

--- Improved direct federal regulatory control over the supervisory personnel in each of the FHl banks, and over all federal as well as state charter applications. We are particularly supportive of Sec. 705, the provision that requires the senior supervisory official of each Federal Home Loan Bank to report to the chief supervisory official of the Chairman of the Federal Home Loan Bank System.

--- Capitalization requirements equivalent to national banks.

--- The improved compensation for staff accompanied with active curtailment of exorbitant management salaries.

--- Improved enforcement powers against insider trading and fraud.

We support with amendments:

--- Early Intervention by the Regulator: The strengthened capability to remove federal insurance where dangerous financial situations are seen to exist and the fund is threatened is necessary, if that step has been proceeded by early intervention of the regulators.

On this point, we must state that the language in the Bush Plan concerning the ability by the FDIC to terminate insurance at various points of perceived high risk or nearing insolvency would cause great confusion on the part of the consumer. As we interpret the Bush Plan, FDIC could terminate federal insurance when it is perceived that a state or federally chartered S&L is seen to be acting in an unsafe or unsound manner, or is otherwise posing undue risks to the insurance fund.

This implies that insurance could be terminated, then reinstated if practices improve, asset levels are raised, and risks restrained. Such shifting of the insurance support would be very difficult to clarify to the consumer, who puts great stock in the solidity of that seal. In fact, we do not understand how this information would be conveyed and interpreted.

Furthermore, this language implies that after insurance is revoked the institution would be allowed to remain open. This is a very confusing situation to the consumer, and we suggest that the mental link between the insurance seal and the name of the institution is so strong for the consumer that the insurance should be removed only when the institution is to be closed. If the institution remains open, we suggest that the situation would remain unclear, and this confusion would cause unnecessary problems and lead to lack of trust in the overall soundness of the seal.

Therefore, in the interests of strong safety and soundness, but for purposes of minimizing confusion and keeping the faith in the seal intact, we support an early intervention provision that would allow the regulator, in this case, the FHLBS, to step in at an early stage, as soon as high risk or unwise, unsafe activities have been detected or reported, to work with that S&L, improve its management, and restore its safety and soundness. At a second stage, if such restraints have not diminished the problem and the asset base drops to 2% points, we support the regulators ability to force a merger or sale of the institution. This would occur before insolvency takes place and thereby protect the insurance fund. Then, as a final step, the insurance fund could terminate insurance when and if the institution in question fails to merge and is thereby threatening the insurance fund. At this point, the consumer would be told that insurance was being removed, that the institution was being closed, and that all deposits were being paid out to the consumer in an orderly fashion.

--- Limitation On High Risk: We believe that the insurance fund should be apprised of all restraining activities of the regulatory body, but that the regulatory body should have the burden of regulating risk restrictions. The language in the Bush Plan implicitly hands virtual control to the FDIC. Since we support the separation of insurance bodies from regulatory bodies, we do not support handing both regulatory and insurance functions over the S&L system to an insurance body, even one as renowned as the FDIC.

In addition, we believe that the arrangement of powers in the Bush Plan does not convey any magic formula for immediate improvement. The Department of the Treasury and the FDIC are both very capable institutions, with capable administrators, but we believe that the improvements in the system will mainly come from improved supervision and capitalization requirements, strong separation of functions throughout the system to minimize potential conflict of interest, and improved public accountability through consumer representation and clear disclosure.

CREDIT UNIONS:

--- We oppose the Bush Plan's call for a change in the credit unions method of computing assets. The credit union insurance fund is remaining solvent while all others are insolvent or are borderline. We point out that credit unions currently receive annual examinations also. This asset accounting requirement would penalize the smallest credit unions which we believe are the very structures that the entire credit union concept is designed to promote. For low-income individuals, minorities, and areas without financial institutions, credit unions are the only mechanism by which people can meet their banking needs adequately. There are many shining examples throughout the credit union history of true cooperative development by those shut out of all other financial systems. This asset requirement is uncalled for and will hurt the smallest credit unions. We ask the Committee to eliminate this provision.

Finally, I suggest that this amendment could have resulted from a developed sense that credit unions are no longer serving the same constituencies as intended or have the community base intended originally. If the Committee feels compelled to address this development, we would ask that it do so through further refinements in the definition of a credit union rather than by penalizing all credit unions, particularly the small, community based unions that are the true example of the original development of the financial structure.

Table I.2:

Asset Composition of all FSLIC-Insured Institutions
by Net Worth Category and for the Industry
June 1987
(Mean values are expressed as a percent of total assets)

	Net worth categories (as a percentage of assets)			
	Less than or equal to zero	Between zero and three percent	Greater than or equal to three percent	Industry
Mortgage assets[a]	59.99	70.38	70.99	69.68
Residential construction loans	3.09	2.16	2.93	2.80
Non-residential construction loans	3.46	1.98	1.47	1.79
Mortgage loans on 1 to 4 dwelling units	28.85	31.70	39.93	37.11
Mortgage loans on 5 or more dwelling units	5.89	4.98	6.11	5.87
Acquisition and development loans	5.26	2.75	1.81	2.36
Mortgage-backed securities	8.69	21.44	14.13	14.97
Non-mortgage assets[b]	40.01	29.62	29.01	30.32
Commercial loans	2.51	1.54	1.87	1.88
Consumer loans	5.47	4.24	4.30	4.41
Direct investment	5.57	3.13	2.04	2.64
Liquid assets	4.60	5.02	5.58	5.36
Goodwill	1.93	2.45	2.15	2.18
Repossessed assets	7.40	2.00	.76	1.72
Investment securities	8.59	7.71	8.84	8.59
Deferred net losses	1.88	.51	.16	.41

[a] Mortgage asset components do not sum to total mortgage assets due to the exclusion of permanent non-residential mortgages, permanent mortgages on loans/contracts to facilitate sale of real estate owned, and permanent mortgages on accrued interest receivable on mortgage backed securities.

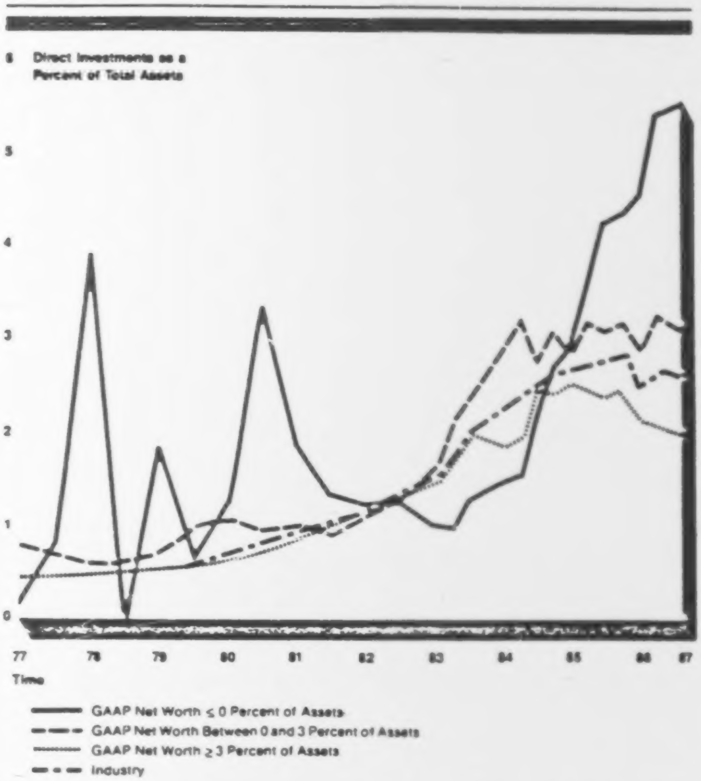
[b] Non-mortgage asset components do not sum to total non-mortgage assets due to the exclusion of fixed assets, financial futures/options, leased property, secured accounts receivable, and other factors.

Note: For definition of various assets see figures that follow as well as glossary.

Source: Federal Home Loan Bank Board Semiannual and Quarterly Financial Reports.

Figure I.12:

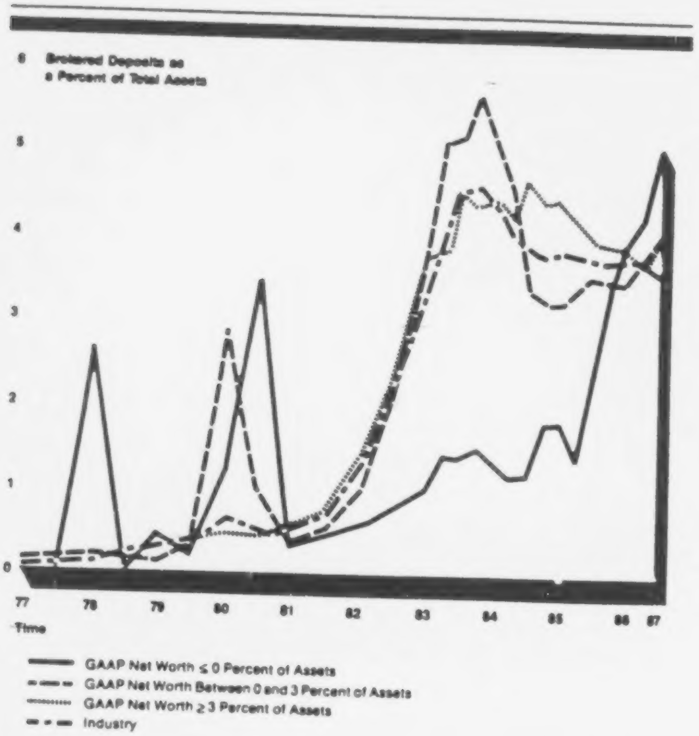
Non-Mortgage Asset Composition: Direct Investment of FSLIC-Insured Thrifts by Net Worth Category and Industry, Year-End 1977 Through Midyear 1987



Note: Years below the horizontal axis are indicated at each year's end, except 1987 which is indicated at midyear.

Figure I.19:

Deposit Composition: Brokered Deposits of FSLIC-Insured Thrifts by Net Worth Category and Industry, Year-End 1977 Through Midyear 1987



Note: Years below the horizontal axis are indicated at each year's end, except 1987 which is indicated at midyear.

and sensitivity to the riskiness of new activities, were drawn more intensely to additional powers and the greater returns they promised. The analysis presented in Table 8 indicates that insolvent thrifts, as would be expected, do indeed have up to a 50% higher level (12.2% versus 8.1%) of non-traditional, often riskier investments than do comparable healthy thrifts.

Table 8
Selected Non-traditional Investment Activity:
By Net Worth
($ in Billions)

	1984	1985	1986	1987
GAAP Insolvent:				
Net Non-mortgage Loans	$6.7	$9.5	$10.5	$10.5
Net Real Estate Held for Development	0.7	1.5	2.1	2.6
Total Assets	113.0	131.8	141.5	142.9
Non-traditional Invstmts as % of Assets (1)	9.2%	12.4%	12.5%	12.2%
GAAP Solvent:				
Net Non-mortgage Loans	$33.3	$45.7	$58.5	$67.3
Net Real Estate Held for Development	3.9	4.4	5.0	4.8
Total Assets	768.7	859.9	981.4	1107.2
Non-traditional Invstmts as % of Assets (1)	6.3%	7.5%	8.0%	8.1%

Note: (1) Includes commercial and consumer loans, direct investment in real estate, and investment in service subsidiaries.

Source: Ferguson & Company.

Texas and California were among those states which offered their thrift institutions the broadest grants of new powers and freedom from regulation. The concentration of non-traditional assets in thrifts in the Dallas and San Francisco districts is far in excess of the national norm. Tables 9 and 10 (attached) demonstrate that thrifts in the Dallas Home Loan Bank district have a dramatically higher level of both direct investment and acquisition, development and construction loans, as much as three times the percentage held by thrifts in other districts. To the extent that the rapid expansion into such non-traditional investments is a contributory factor in the deteriorating

[illegible] STATISTICS OF FSLIC-INSURED INSTITUTIONS
CLASSIFIED BY GAAP SOLVENCY STATUS AND FHLBANK DISTRICT

SECOND QUARTER 1988

(DOLLAR AMOUNTS IN MILLIONS)

ALL FIRMS	United States	Boston	New York	Pitts-burgh	Atlanta	Cincin-nati	Indian-apolis	Chicago	Des Moines	Dallas	Topeka	San Fran-cisco	Seattle
Number	3,092	90	231	189	605	349	159	333	183	469	165	216	103
Assets	1,290,048	29,693	118,921	46,778	199,618	74,023	52,167	85,853	55,857	132,427	60,432	389,218	45,061
Regulatory Capital	47,370	1,843	6,462	2,822	10,296	4,278	2,809	5,625	2,032	(9,976)	1,453	17,456	2,271
Reg. Cap.-to-Assets Ratio	3.67%	6.21%	5.43%	6.03%	5.16%	5.78%	5.38%	6.55%	3.64%	-7.53%	2.40%	4.48%	5.04%
GAAP Capital	29,730	1,670	5,038	2,327	7,825	3,493	2,239	4,565	1,052	(13,850)	577	13,095	1,698
GAAP Cap.-to-Assets Ratio	2.30%	5.62%	4.24%	4.97%	3.92%	4.72%	4.29%	5.32%	1.88%	-10.46%	0.95%	3.36%	3.77%
Net Operating Income	225	35	204	82	176	150	113	162	39	(1,159)	(48)	425	48
Net Nonoperating Income	(3,291)	6	(67)	(21)	(157)	(46)	(14)	(51)	(75)	(2,460)	(291)	(120)	3
Taxes	581	16	65	27	61	45	38	58	9	(14)	36	220	21
Net Income	(3,646)	26	72	35	(43)	60	61	53	(44)	(3,605)	(375)	85	30
Return on Assets (ROA)	-1.13%	0.35%	0.24%	0.30%	-0.09%	0.32%	0.47%	0.25%	-0.32%	-10.89%	-2.48%	0.09%	0.27%

GAAP SOLVENT FIRMS	United States	Boston	New York	Pitts-burgh	Atlanta	Cincin-nati	Indian-apolis	Chicago	Des Moines	Dallas	Topeka	San Fran-cisco	Seattle
Number	2,595	89	215	184	552	324	143	276	152	278	113	186	83
Assets	1,101,850	29,545	113,304	43,665	182,883	65,566	49,610	73,400	43,461	65,101	45,548	350,826	38,940
Regulatory Capital	66,847	1,856	6,432	2,788	11,040	4,372	2,922	5,913	2,148	4,342	2,362	20,125	2,546
Reg. Cap.-to-Assets Ratio	6.07%	6.28%	5.68%	6.38%	6.04%	6.67%	5.89%	8.06%	4.94%	6.67%	5.19%	5.74%	6.54%
GAAP Capital	55,932	1,688	5,296	2,393	9,131	3,842	2,445	5,331	1,625	3,248	2,008	16,793	2,132
GAAP Cap.-to-Assets Ratio	5.08%	5.71%	4.67%	5.48%	4.99%	5.86%	4.93%	7.26%	3.74%	4.99%	4.41%	4.79%	5.48%
Net Operating Income	1,772	36	209	82	228	160	121	196	78	(23)	19	593	73
Net Nonoperating Income	(302)	4	(56)	(21)	(90)	(31)	(11)	(22)	(23)	(133)	29	57	(6)
Taxes	575	16	64	27	60	46	38	57	14	(25)	36	220	21
Net Income	896	24	88	35	79	83	73	116	42	(131)	11	430	46
Return on Assets (ROA)	0.33%	0.33%	0.31%	0.32%	0.17%	0.51%	0.59%	0.63%	0.38%	-0.80%	0.10%	0.49%	0.48%

GAAP INSOLVENT FIRMS	United States	Boston	New York	Pitts-burgh	Atlanta	Cincin-nati	Indian-apolis	Chicago	Des Moines	Dallas	Topeka	San Fran-cisco	Seattle
Number	497	1	16	5	53	25	16	57	31	191	52	30	20
Assets	188,199	148	5,617	3,113	16,735	8,457	2,558	12,453	12,396	67,326	14,884	38,391	6,122
Regulatory Capital	(19,477)	(14)	30	34	(744)	(94)	(113)	(288)	(116)	(14,319)	(909)	(2,669)	(275)
Reg. Cap.-to-Assets Ratio	-10.35%	-9.18%	0.53%	1.10%	-4.45%	-1.12%	-4.43%	-2.31%	-0.94%	-21.27%	-6.10%	-6.95%	-4.49%
GAAP Capital	(26,203)	(18)	(258)	(66)	(1,306)	(349)	(206)	(766)	(573)	(17,098)	(1,432)	(3,698)	(434)
GAAP Cap.-to-Assets Ratio	-13.92%	-12.03%	-4.59%	-2.12%	-7.81%	-4.12%	-8.05%	-6.15%	-4.62%	-25.40%	-9.62%	-9.63%	-7.09%
Net Operating Income	(1,547)	(1)	(5)	(0)	(53)	(10)	(8)	(34)	(39)	(1,137)	(66)	(168)	(25)
Net Nonoperating Income	(2,989)	1	(10)	(0)	(68)	(14)	(3)	(28)	(52)	(2,327)	(320)	(177)	9
Taxes	6	0	1	0	0	(1)	0	1	(5)	11	(0)	0	0
Net Income	(4,542)	0	(16)	(1)	(121)	(23)	(11)	(63)	(86)	(3,474)	(386)	(345)	(16)
Return on Assets (ROA)	-9.65%	0.34%	-1.15%	-0.07%	-2.90%	-1.09%	-1.78%	-2.03%	-2.77%	-20.64%	-10.37%	-3.59%	-1.07%

VII. FUNDING SOURCES: BROKERED DEPOSITS (Percent of Total Assets)

Year End	United States	Federal Home Loan Bank District											
		Boston	New York	Pitts-burgh	Atlanta	Cincin-nati	Indian-apolis	Chicago	Des Moines	Dallas	Topeka	San Fran.	Seattle
1970	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
1970	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
1971	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
1973	0.1%	0.0%	0.0%	0.2%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.2%	0.2%	0.1%
1974	0.1%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%	0.1%
1975	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%
1976	0.1%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%
1977	0.1%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.3%	0.1%
1978	0.1%	0.0%	0.0%	0.1%	0.0%	0.0%	0.0%	0.1%	0.1%	0.2%	0.1%	0.3%	0.1%
1979	0.3%	0.0%	0.0%	0.0%	0.1%	0.0%	0.0%	0.1%	0.1%	0.1%	0.0%	1.2%	0.1%
1980	0.6%	0.0%	3.5%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.2%	0.0%	1.3%	0.1%
1981	0.5%	0.1%	0.1%	0.0%	0.1%	0.1%	0.0%	0.1%	0.1%	0.5%	0.0%	1.8%	0.2%
1982	1.4%	0.1%	0.4%	0.0%	0.4%	0.2%	0.6%	0.1%	0.1%	2.6%	0.4%	3.8%	1.0%
1983	3.5%	0.3%	0.7%	0.4%	0.8%	0.9%	3.0%	0.4%	0.6%	6.5%	1.5%	8.8%	2.5%
1984	4.4%	0.3%	0.8%	0.3%	0.9%	0.6%	4.2%	0.5%	0.3%	5.6%	3.2%	11.1%	2.5%
1985	3.8%	0.4%	0.9%	0.3%	1.2%	0.6%	4.1%	0.4%	0.4%	5.2%	3.7%	8.9%	1.9%
1986	3.8%	1.0%	0.9%	0.3%	1.3%	0.5%	4.2%	0.3%	0.3%	6.5%	5.0%	7.7%	1.3%
1987	5.1%	5.4%	1.3%	0.7%	2.2%	0.7%	4.9%	0.5%	0.5%	9.1%	6.1%	9.7%	2.1%

XIV. ASSET COMPOSITION: DIRECT INVESTMENTS (Percent of Total Assets)

Year End	United States	Federal Home Loan Bank District											
		Boston	New York	Pitts-burgh	Atlanta	Cincin-nati	Indian-apolis	Chicago	Des Moines	Dallas	Topeka	San Fran.	Seattle
1970	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
1971	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.2%	0.0%	0.4%	0.0%
1972	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.4%	0.0%	0.3%	0.0%
1973	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.3%	0.5%	0.1%	0.3%	0.0%
1974	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.3%	0.6%	0.0%	0.5%	0.0%
1975	0.2%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.6%	0.0%	0.4%	0.0%
1976	0.1%	0.1%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.2%	0.6%	0.0%	0.4%	0.0%
1977	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.2%	0.5%	0.0%	0.3%	0.0%
1978	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.5%	0.0%	0.4%	0.0%
1979	0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.5%	0.0%	0.4%	0.0%
1980	0.2%	0.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.7%	0.0%	0.6%	0.0%
1981	0.3%	0.1%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.2%	0.8%	0.0%	0.8%	0.0%
1982	0.4%	0.1%	0.0%	0.0%	0.1%	0.0%	0.0%	0.1%	0.2%	1.0%	0.0%	1.0%	0.2%
1983	0.5%	0.1%	0.0%	0.0%	0.2%	0.1%	0.0%	0.3%	0.3%	1.2%	0.0%	1.1%	0.2%
1984	0.6%	0.1%	0.0%	0.0%	0.1%	0.0%	0.0%	0.1%	0.3%	1.2%	0.0%	1.3%	0.5%
1985	0.7%	0.2%	0.1%	0.0%	0.2%	0.1%	0.1%	0.1%	0.4%	1.9%	0.2%	1.2%	0.6%
1986	0.7%	0.1%	0.1%	0.1%	0.3%	0.2%	0.1%	0.1%	0.3%	2.3%	0.2%	1.1%	0.4%
1987	0.7%	0.2%	0.1%	0.1%	0.3%	0.2%	0.0%	0.1%	0.3%	2.7%	0.2%	0.9%	0.5%

The **Chairman**. Thank you very much. I appreciate the thoughtfulness and the care of all of the presentations today. We will make the full statements a part of the record and we are receiving other suggestions from other groups that have asked to submit their ideas. We will consider those just as carefully and fully as we will those that have been presented here orally today.

I'd like to ask each of you a series of questions. I feel very strongly that the Federal deposit insurance should not be stretched out to cover things that States may invent as add-ons to a Federal thrift charter.

That is one of the issues that we are going to have to settle in this bill and that is whether or not State-granted powers should be connected to the Federal deposit insurance system and should the Federal taxpayer be responsible for underwriting the problems.

I'm wondering if I could get as clear an answer as each of the three of you could give on that specific question. Why don't we start with you, Mr. Gnaizda.

FEDERAL INSURANCE AND ADDED STATE POWERS

Mr. **Gnaizda**. Mr. Chairman, as you know, the biggest problem probably in regard to add-ons has been in California and it's against the interest of minorities and the poor to permit that. We feel very strongly that there should be essentially no insurance protection for State add-ons. We feel we must move as closely toward savings and loans returning to narrow home investments as you and Congressman Annunzio have suggested.

The **Chairman**. Miss Meier.

Miss **Meier**. We second that. We think that consumers and the public in general have a very large interest in maintaining the safety and soundness of the industry and the insurance fund and that runaway legislatures pose great risks to maintaining safety and soundness.

From a public policy standpoint, we also think that it's fundamentally fairer when a State-chartered institution is getting Federal insurance to have to follow Federal guidelines as to what type of activities it can engage in.

The **Chairman**. Miss Miller.

Miss **Miller**. We agree. Basically we think this is not in all cases, but in this situation that because you are federally insured you have to—but one of the points you made near the beginning and I might have misunderstood is that a connection for State-chartered thrifts, that they have to follow—I thought what you were trying to say is high risk in State-chartered thrifts should be avoided. We would carry that even in national, federally chartered thrifts. We feel it should be consistent throughout.

The **Chairman**. Well, that's one of the issues we're going to decide, and it goes to the center of a question of what the charter should be. If we have a standard, 50-State charter that rests on Federal deposit insurance, then the question of what that charter looks like, the percentage that's devoted to the qualified thrift lender activities and then the wraparound activities also become very important.

If you assume that the qualified thrift lender test would be hypothetically at 70 percent rather than 60 percent, I would welcome having your suggestions as to how you would in turn define what fits into that category of 70 percent.

In addition, I'd ask you to give some thought to what the remaining 30 percent of activities—the wraparound activities—that would go with it and would make up the full operational charter going forward.

I'd ask you to think about it this way. It seems to me if we're going to maintain a specialized industry in the future—and that is really sort of at the heart of this proceeding—it's not just to clean up the problem that's developed, but it's to set a course that will carry us ahead hopefully for some number of decades into the future. I'm struck by one statistic that indicates that still roughly half of all the mortgage originations in the country are occurring with savings and loans, roughly 50 percent of the originations.

Now to me, that's a very important fact because if you think of the country as a whole, all the separate communities around the Nation, the ability for somebody to go out and be able to get a mortgage is very critical.

Now a lot of the institutions that originate the mortgages don't necessarily keep them because they get packaged and sold. So, there's a secondary market in mortgages and that's all part of the current system that we have. But the origination side it seems to me is really the nexus with the consumer, if you will. If the consumer, who is after a home mortgage, can't find somebody to make it at some reasonable and affordable rate, then they are not going to be able to cross over into homeownership.

So, I would like you to give some thought specifically to both the definition of the QTL portion and what would constitute a sensible set of add-on authorities, recognizing that one savings and loan might choose in its given area to concentrate more on one area of the additional activities that would be authorized and a different one some other place might see it very differently and do it differently.

I think eventually and ultimately it has to meet the test as well of being able to be a charter that can be sufficiently profitable that can in fact attract capital and hold capital so that we maintain safety and soundness and keep the industry going.

In a sense it's got to be a business charter that fits a public purpose, and it's got to work both ways. It has to meet the public interest on the one hand and it also has to meet an economic test of sufficiency on the other hand.

So if you would, I would appreciate it if each of you would prepare a response to that question, and let us have it.

Let me just raise one other thing before yielding to Senator Graham. Well, let me yield to Senator Graham at this point.

Senator GRAHAM. Thank you, Mr. Chairman.

I have one issue that I would like to raise which was a theme that ran through all of your testimony, and that was the desire to use this current legislation and the circumstance in which we find ourselves as an opportunity to encourage these institutions to a greater effort in low and moderate income housing.

My concern is that in a deregulated economic environment in which these institutions have to compete with a variety of other institutions, and especially now with the requirements for increased capital, they will be institutions sufficiently attractive to bring in the capital to meet those higher standards.

How do you balance those marketplace forces with the laudable goal of increasing low and moderate income housing?

LOW AND MODERATE INCOME HOUSING

Mr. Gnaizda. Senator, I would respond that it cannot easily be done under the Bush proposal. That is why in our green-lining proposal we suggest that there should be no imposition of onerous fees on the savings and loans. We are in favor, as set forth in our prepared testimony, of a wide range of credits, including different capital requirements.

For example, we met with the minority thrift association yesterday and we discussed with them, given their commitment to the inner-cities and the evidence over the last decade that their loan portfolio has been less risky than, for example, the majority of loans by many savings and loans, that they should get additional credits so that the capital requirements might be less for inner-city loans.

For example, one minority thrift gave us a statement regarding loans to black churches over the last 30 years. He said of all the loans made to black churches, 151 in total, only two had presented a problem and they were easily refinanced.

So that would be the first point we would make, which is we must figure out innovative incentives.

Second, we have to provide different capital requirements for institutions that are dedicated to the inner-cities and low income groups. Otherwise, the savings and loan industry will continue as a major red-liner, either deliberately or inadvertently.

Miss Meier. Senator, we asked ourselves the same question, that we can't foist on the thrift industry requirements to engage in lending that would make the extinction of the industry a foregone conclusion. That is why we turned to the cash advance program, which as I described would be set up in the Federal Home Loan Banks. It would take advantage of the favorable rates at which the Home Loan Banks are able to raise money and, in turn, translate those favorable rates into favorably rated cash advances and loans to targeted borrowing populations.

We have not suggested that every S&L meet some test under which they would have to engage in a certain percentage of this type of lending, but the funds would be made available. The Home Loan Banks would be required to make the funds available for this type of targeted lending and as long as the individual S&L member can borrow the funds at reduced rates, then they can turn around and relend for public purposes at a slight profit.

Also, we have encouraged and go into detail in our testimony that Congress look to shifting some of the housing subsidy now provided to wealthier home owners to meet the subsidy needs of this type of targeted lending program. So that essentially we would have the S&Ls acting as a vehicle for this type of targeted lending and the cost in any negative sense wouldn't be coming out of the hide of the industry itself.

Senator GRAHAM. That idea, would that be through the tax code or how would you do that?

Miss MEIER. The modification of the housing subsidy would require modification to the tax code. A reduction in the current mortgage interest deduction now given is necessary. Home owners at this point, if you have a $1 million estate you can deduct the entire interest on it. We think that's an unjustifiable housing subsidy to those who don't need it and that we need to reduce that interest deduction cap to still accommodate middle and even upper middle income home owners, but to eliminate the subsidy to the very wealthy, to turn it to those who are in greatest need.

We are also looking for incentives that would be provided within the industry, not just the S&L industry but the banking industry too, and one idea we have come up with which we particularly like is that we would be giving an insurance premium discount to institutions who engage in this type of targeted lending. The discount could be a waiver of the assessment on those deposit amounts that equal assets invested in targeted lending.

To avoid any type of safety and soundness problem to the insurance fund, the rest of the industry would be offsetting that discount by a slight increase in premium and thereby we would be getting the entire industry, either directly or indirectly, participating in public purpose lending.

Miss MILLER. We tackle it from a slightly different standpoint but end up in the same place.

Basically, as we look at it, first, even from a safety and soundness standpoint, when you look at housing lending, we do not agree that the facts show that you need to move away from high percentages of housing lending in order to diversify. It's not that we're against such diversification and we feel that some of that is perfectly allowable within even a publicly insured institution where the risks are not so high, but the facts—we've been trying to collect statistics which take a look at the whole question of mortgage lending from a safety and soundness standpoint.

You are all aware that ever since the insolvencies occurred and that there are statistics available—we've included some of them in our testimony—which show correlations between those thrifts that moved into a far lower level of mortgage origination and insolvency. We think there is a connection on that point.

We also think that when you look at patterns of what's happened since, many of the thrifts, what they've been doing with them to get them back to a safer position has been going back to mortgage origination. I've been seeing it in articles all over. I've been seeing it in terms of when thrifts have been holding their own conferences. For the last 2 to 3 years they have been recommending that they return to mortgage lending. It's not as profitable in all instances, but it's a good, strong bread and butter. We feel from a public standpoint, a good strong bread and butter may not be as profitable, but it would keep us out of the insolvent situation that we're facing right now.

The only area where we feel you really need to take a look at subsidizing is questions on the low income base because you really need to sensitize part of the program, if you want to take it on, from a low income standpoint.

We do support doing that and we support uses of things like the mortgage interest deduction to help subsidize that so that you're not extending the thrifts out into a position where they are going to be forced to take a loss on any of these. I would like to point out, I've been working with a number of organizations for about the last 15 years that about 10 years ago decided they couldn't work with banks any more because they couldn't get low income funding. They have started revolving loan funds. One of them is up to $40 million in size now, and they've only had one delinquency.

My only reason for raising that fact is I don't think there's corresponding statistics that you really—the problem is with mortgage lending and mortgage origination is it takes time and it takes a lot of people management. And that has become more costly. So there's been a move away from that into a whole secondary market approach, streamlining it and cutting your labor time.

The only trouble is from a public institution framework it hasn't resulted in solvencies nor in really decent end results on the public end. So since we're dealing with a publicly insured body here, we would recommend for both safety and soundness as public interest.

I finally only point out that when you take a look at the banks themselves, where we're not even today arguing— we would probably carry this argument somewhat into the banks situation, but they're facing insolvencies. They had 400 over the last couple years. This is not a situation that diversification necessarily ends up in streamlining and improving the situation.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Graham.

We will have other questions to submit to you from other members of the committee who had to come and leave and others who have not been able to arrive this morning. I particularly would like to have in writing the things that I asked for a while ago, and as soon as you can do that it would be helpful because we're going to get moving into the drafting and the adjustment phase.

With that, let me thank all of you for appearing this morning and I will now ask our second panel if they will prepare to come to the table. We will hear first from Mr. Al Williams, who is the chairman of the Credit Union National Association, and then from Mr. Kenneth Robinson who is the president of the National Association of Federal Credit Unions.

Mr. Robinson, let us hear from you at this time.

STATEMENT OF KENNETH L. ROBINSON, PRESIDENT, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. ROBINSON. Thank you, Mr. Chairman.

Good morning to you and the other distinguished members of this committee. My name is Ken Robinson. I am coming to you as the chief executive officer of the National Association of Federal Credit Unions, which represents the interest of credit unions that are chartered by the Federal Government.

Prior to assuming my present duties, I served for 33 years with the U.S. Marine Corps. Early in my career I came to Washington. I needed a house and a car and I needed a loan. I got the loan from Navy Federal Credit Union, I got the car, and I've been a member ever since.

During my military years I had ample opportunity to work with credit unions. In fact, for 10 of those years I served as a volunteer with credit unions. I served on the board of directors of three different credit unions, one a very small one, less than a million dollars; one the largest in the world.

Having completed active service, I came to Washington again and worked with the National Credit Union Administration as a consultant, providing management assistance to troubled credit unions.

On behalf of our member credit unions and the millions of Americans who are their members, I'd like to say thank you for inviting us to come here this morning and have our views made known and heard.

I have submitted a detailed longer statement. I would just like to touch on the highlights.

Credit unions recognize the seriousness and complexity of the problems facing the savings and loans, the FSLIC, and the FDIC. We are pleased that the administration, the President, and Congress have moved smartly to tackle those problems and, of course, we are hopeful that you will come out with good solutions to them. We certainly want to be part of the solution and not part of the problem and any help we can offer that's beneficial we'd be pleased to do that.

Credit unions by and large support the bill and they support the purposes of the bill, but we do have a couple of concerns. One of them is very major and that has to deal with that provision of the bill which relates to restructuring the National Credit Union Share Insurance Fund.

Some have characterized that provision as being technical in nature, noncontroversial, and nothing more than an accounting adjustment. That is the wrong interpretation and nothing could be further from the truth.

The provision actually strikes at the heart of the strength of the National Credit Union Share Insurance Fund. It would weaken the fund at a time when we really can ill afford to be weak.

Today, the National Credit Union Share Insurance Fund is strong and it's getting stronger because the fund is built on three sturdy financial legs.

One of those is the annual premium, one-twelfth of 1 percent, which banks and S&L's also pay.

The second part of that is a deposit of 1 percent of insured shares, and that is unique to credit unions. The others do not do that.

The third source of income for the Share Insurance Fund are the earnings on both the deposit and the retained earnings or the equity of the fund.

Those are routine measures for routine times. They provide a constant inflow of dollars to meet normal day-to-day requirements of overhead and losses.

There is an additional provision, however, to cope with catastrophe, and this provision is contained in the current law which governs the NCUSIF. That provision provides that, if the NCUSIF has to draw down on the deposit of credit unions with the fund in order to meet insurance losses, credit unions will be required to replenish those funds that are drawn down.

S. 413 would cause credit unions to phase out the deposit by writing it down over 8 years thereby reverting the NCUSIF to a premium-only fund. This is exactly the condition the fund was in prior to 1984 when we recapitalized it. Gone would be the payment to augment the fund made each year to keep pace with the share growth. That is to say that if insured shares grow in credit unions then the credit unions send more money equal to 1 percent of growth to Washington to cover that additional exposure. That provision would be gone under S. 413.

Gone, too, would be the requirement to replenish the fund in the event of catastrophe. In other words, what the fund had when it met the catastrophe is what it would have to deal with that catastrophe. Under the present arrangements, NCUSIF could go to the credit unions and get additional funds if NCUSIF's ratio dropped below 1 percent.

If there is no premium requirement during the 8-year transition period, as testified by Secretary Brady to this committee, then the NCUSIF would have no income between now and 1999 except for the earnings of the money that is now in the fund.

Under this scenario, the fund would start a steady decline which wouldn't stop until the next century. But should a premium be required, Mr. Brady's testimony to this committee notwithstanding, then we would have the anomaly of credit unions whose fund is healthy and strong paying a combined premium write-down of 20.8 basis points, while other financial institutions—banks, for instance—whose fund lost $4.7 billion last year according to Chairman Seidman, they would be paying a lesser premium of only 12 or 15 basis points. I submit that's not a very good reward for staying out of financial difficulty.

Between 1970 and 1983, the Share Insurance Fund was a premium-only fund. That system worked OK except for one thing. It didn't provide for growth and this period became a time of explosive growth for credit unions. So by 1982, which was a difficult year for losses, we decided that something had to be done to make the fund better. We had to find a better way.

So we worked with Congress, this committee, the administration, the entire credit union community, and a better system was devised. In January 1985, the credit unions sent $800 million to Washington as a deposit. Over the years, credit union shares doubled and so did deposits credit unions placed in the Share Insurance Fund. What started out as $800 million in 1985 is now $1.6 billion.

The retained earnings portion, or the equity of the NCUSIF, also grew from roughly $200 million in those days to approximately $400 million today.

Just as a matter of perspective, I might point out that if you look at the average losses of credit unions over the last 10 years, they come out to about $40 million. There's just under $400 million in the equity of the fund today. So one could say the equity could handle routine losses over 10 years or you could say the equity covers 1 year's loss ten times over. Or looking at another way, since the inception of the Share Insurance Fund in 1970 until today, the losses over those entire 19 years have amounted to just over $400 million, $431 to be precise. And the equity being today just under $400 million is very nearly the equivalent of what the fund has paid out in the entire life of the fund since 1970.

That's not to say that the future 19 years will be like the past 19 years, but certainly we would not ignore history in trying to look to the future.

This past January, credit unions added another $110 million to their deposits because they grew $11 million in share deposits in 1988. The earnings on these funds total $133 million. That's enough to cover the $30 million of overhead and the $60 million of losses which credit unions experienced last year—a little high—and still leave $43 million to be added to retained earnings.

If S. 413 had been in place, credit unions would not have sent that money to Washington. Clearly, it is the deposit which makes the difference. The deposit keeps the fund in tune with the growth of credit union shares and it earns the money necessary to cover overhead, losses and provide a surplus as well.

Some characterize our deposits as funny money. Let me suggest that the $110 million we sent in January or the $800 million we sent in 1985, there was nothing funny about those dollars. They are hard, green dollars and every one contributed to reducing our deficit.

I have submitted a longer statement and I will terminate on this point. Thank you very much, Mr. Chairman.

[The complete prepared statement of Kenneth L. Robinson follows:]

TESTIMONY OF KENNETH L. ROBINSON

PRESIDENT

THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

MARCH 15, 1989

Mr. Chairman and distinguished members of the Committee, I am Kenneth L. Robinson, President of the National Association of Federal Credit Unions. NAFCU is the only national organization exclusively representing the interests of credit unions chartered by the federal government, all of which are required by law to be federally insured. There are approximately 14,113 federally insured credit unions nationwide with over 51.8 million members.

NAFCU member credit unions are deeply concerned by Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act (S. 413) as proposed by the Administration. This legislation would require all 9,275 federal credit unions and 4,838 state chartered, federally insured credit unions to expense over eight years the one percent of insured shares now held in deposit by the National Credit Union Share Insurance Fund (NCUSIF). As a result, title to these funds -- which in fact are an asset of credit unions available for immediate use by the National Credit Union Share Insurance Fund if necessary -- would transfer from credit unions and their members to the federal government.

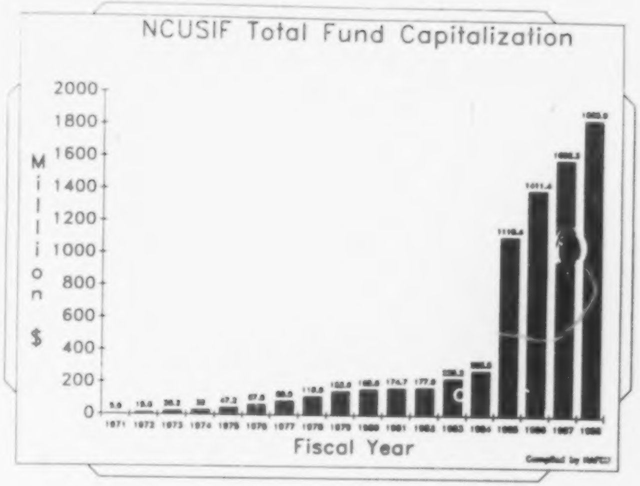
This proposed change has been characterized as a technical, noncontroversial accounting adjustment which would strengthen the National Credit Union Share Insurance Fund. This generalization is an extremely inaccurate assessment of the impact this change would have upon credit unions and the NCUSIF. The fact is this proposal is neither noncontroversial nor will it strengthen the NCUSIF. Indeed, the proposal would weaken credit union share insurance. This proposal would fail to bring a single new dollar to Washington; to the contrary, it would bring less money into the NCUSIF in the future than is currently provided. Furthermore, it represents a hasty, unilateral, and ill-advised recision of one of the key provisions of the carefully-crafted NCUSIF recapitalization agreement between Congress, the Administration, and the credit union community. Such a change is unwise, unwarranted and unnecessary. The NCUSIF is now and consistently has been since its voluntary recapitalization by credit unions in 1985 the healthiest of the three federal deposit insurers. For all these reasons, the nation's federally insured credit unions oppose this inclusion of credit unions in the Administration's proposed legislation, and urge you to do likewise.

As a lifelong credit union member, I am pleased to appear before the Committee today. During my thirty year military career, I served as a volunteer director to three credit unions. Afterwards, I served as a consultant to the National Credit Union Administration (NCUA), assisting the agency's handling of financially troubled credit unions. I assumed my current position in January 1984, on the eve of the NCUSIF recapitalization, and was personally involved at every level of planning and implementation of the recapitalization. Thus, I have a rather unique perspective on the subject on which I am testifying today.

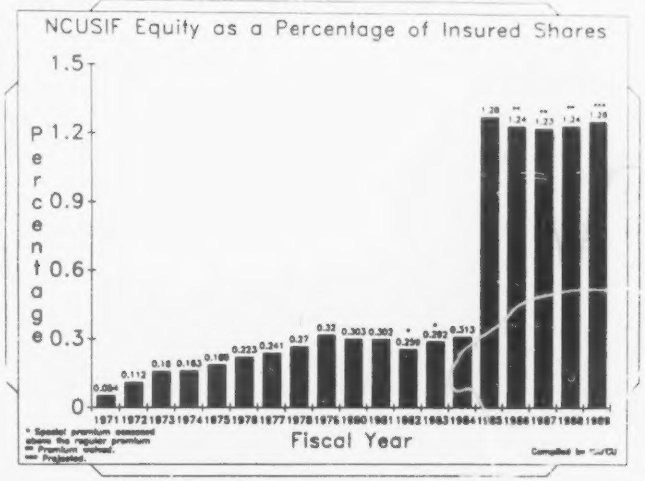
The History of Federal Credit Union Share Insurance

To understand fully its negative impact, the proposal contained in S. 413 must be examined in the historical context of credit union share insurance. Unlike its counterparts in the bank and savings and loan industries, the NCUSIF was not established during the Depression era. Rather, it was not until the late 1960's that federal credit unions sought the establishment of a federal deposit insurance fund. These efforts -- which I should note served as the genesis of the National Association of Federal Credit Unions -- were rewarded by Congress in 1970 when it enacted legislation authorizing the establishment of the NCUSIF. To further distinguish the NCUSIF from its counterparts, not a single taxpayer dollar was ever provided to assist credit unions establish the NCUSIF. By comparison, FDIC received $289 million and the FSLIC received $100 million in seed money from the U.S. Treasury. These amounts would total over $3.4 billion in 1989 dollars. Further, credit unions have neither sought nor ever needed taxpayer funds to operate or recapitalize the NCUSIF.

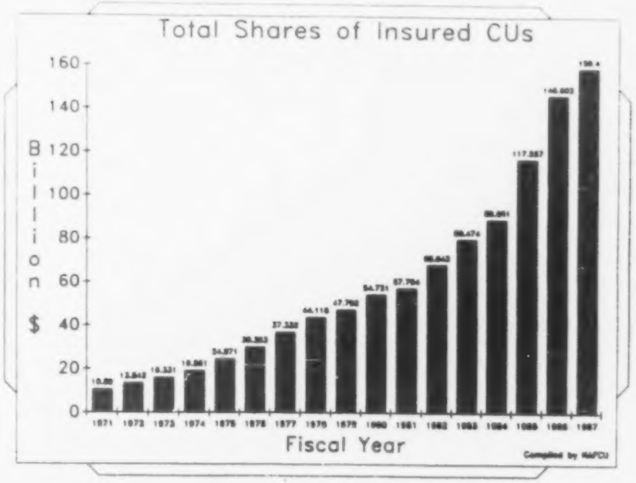
Over the course of the NCUSIF's first decade and a half, it became increasingly obvious that a premium-based insurance system was inappropriate for credit unions because such a system was incapable of keeping pace with the rapid growth experienced at insured institutions. From 1971 to 1984, the NCUSIF grew from just under $6 million to $285 million -- an increase of a remarkable 4,831 percent, as indicated by the chart on the following page.



During this same period, the NCUSIF's ratio of equity to insured shares increased nearly six-fold to 0.313 percent.



Yet, in spite of this notable success, this growth failed to capitalize the NCUSIF to a level acceptable to the credit union community as was originally expected. This was because insured shares during this period grew by an unprecedented 823 percent from $10.9 billion to $89.7 billion.



The 1984 NCUSIF Recapitalization

It is for this reason that in 1984 the credit union community presented to Congress a proposal to replace the exclusively premium-based insurance system with a restructured, modernized, "pay-as-you-go" system. The 1984 NCUSIF recapitalization plan -- which was conceived by the credit union community, presented to Congress by the credit union community and consisted solely of credit union funds -- very much reflects the cooperative and mutual nature of the institutions it serves to insure.

That the NCUSIF is structured in a fashion different from the other federal deposit insurers is not inappropriate. Mr. Chairman, in rising on the floor of the Senate on May 18, 1984 to lend your support to the NCUSIF recapitalization legislation (S. 2522) which you characterized as "a reasonable and well thought out approach to the needs of credit unions," you explained it best when you said,

> [T]hose of us who serve on the Banking Committee appreciate those unique characteristics of credit unions which distinguish them from other institutions in the financial services industry. The National Credit Union Share Insurance Fund is one example of that distinctive difference.

Senator Riegle, you were not alone in supporting this legislation. As the primary sponsor of the recapitalization plan and then Chairman of the Senate Banking Committee, Senator Garn (R-UT) noted that this legislation "provides for a huge increase in funding for the National Credit Union Share Insurance Fund, (NCUSIF) with a corresponding decrease in the Federal deficit." Senator Garn further noted that when the NCUSIF recapitalization plan was being debated by the Senate in May of 1984, the bill had in fact at the time the support of the Treasury Department, as well as NAFCU, NCUA and CUNA, "...all of which have been helpful in moving the legislation forward." This plan enjoyed strong bipartisan support. Senator Cranston (D-CA) noted that the revised credit union insurance fund was "characterized by foresight and realistic good judgement." In addition, Senator D'Amato (R-NY) spoke favorably of this plan on the Senate floor, noting the significant positive impact that will flow from the revised credit union insurance fund, which "...is unique from other federally administered deposit insurance funds." [For complete text of Senate debate on the 1984 NCUSIF recapitalization legislation, please see Appendix A.]

The 1984 NCUSIF recapitalization plan provided that federally-insured credit unions were to maintain deposits equal to one percent of their total insured shares with the NCUSIF. Furthermore, this carefully-crafted package which was agreed to by Congress, the Administration, and credit unions provided that insured credit unions could keep those funds on their books as assets, while the NCUSIF keeps the interest earned off these funds. The plan, which was enacted by Congress and signed into law by President Reagan on July 18, 1984, has two provisions related to credit unions keeping those funds as assets which are absolutely crucial to the continued safety and soundness of the funds. Both would be eliminated to the detriment of the NCUSIF by the proposal under consideration today.

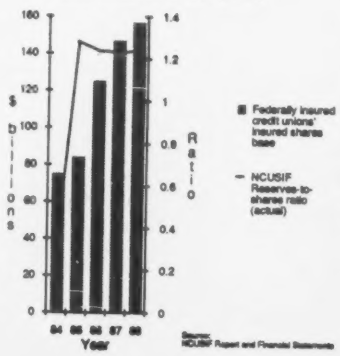
The Impact of the Administration's Plan

The first is that as a credit union grows, it is required to adjust annually the funds held on deposit at NCUSIF to reflect that growth. For example, if a credit union grows by 10 percent in one year, the funds which the credit union maintains at NCUSIF must likewise be increased by 10 percent at the end of that calendar year. This aspect of the 1984 recapitalization plan was designed to guarantee that NCUSIF would grow at the same rate as the credit unions it insures. which was the fund's most serious deficiency prior to 1985. As previously explained, although the NCUSIF's funds grew at a steady pace throughout the 1970's and into the 1980's, its equity ratio had difficulty rising above 0.30 percent because of the rapid growth of insured shares. This feature, which would be eradicated under Title XI of S. 413, remains crucial today.

Notwithstanding assertions by the Administration to the contrary, the change proposed in Title XI would not strengthen the NCUSIF but, rather, would weaken it for just this reason. NAFCU projects that had the plan, as described by Secretary Brady, been in effect in the five-year period of 1984-1988, the NCUSIF reserves-to-share ratio -- which has stood between 1.23 and 1.30 percent since 1985 -- would have steadily declined to 0.64 percent because of the loss of the annual one percent adjustment. Chart I below shows the result of the 1984 NCUSIF recapitalization. Since then the NCUSIF has maintained a relatively constant level of reserves to shares insured (the solid line reflects the ratio of reserves to insured shares; the vertical bar at the right measures the ratio of insurance fund reserves to total shares). Chart II shows the result of the Bush Administration's plan on the NCUSIF had it been in effect since 1985. The ratio of reserves to shares insured, under this plan, would have consistently declined during the period 1985-88 (as illustrated by the solid line, reading from left to right) to a level roughly half of what it actually is today. This is the result of eliminating the annual adjustment of credit union funds held on deposit at NCUSIF to reflect credit union growth while the insured share base increased by over 75 percent, as manifested by the gray bars on both Charts I and II.

Chart I

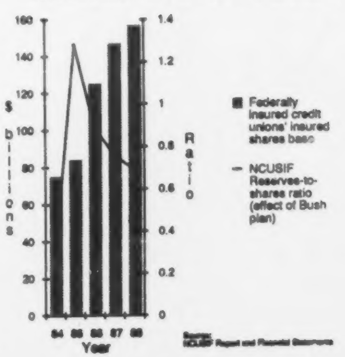
Condition of NCUSIF 1984-88 (actual)



Source:
NCUSIF Report and Financial Statements

Chart II

Condition of NCUSIF 1984-88 (If Bush plan in effect)



Source:
NCUSIF Report and Financial Statements

Thus, from this perspective, Title XI defies the common wisdom that a fund with more money in it is better off than a fund with less! The effect of the Administration's proposal is that it would make the NCUSIF unacceptably and inexcusably vulnerable to credit union growth.

The second effect of requiring credit unions to maintain a deposit at the NCUSIF equal to one percent of total insured shares is the implicit guarantee that, even in the worst case scenario, NCUSIF will be able to maintain a reserves-to-share ratio of at least 1.00 percent. This is true because NCUA currently has the statutory authority -- in the improbable event that it ever becomes necessary -- not only to employ credit union assets under its control and maintained at the NCUSIF but, more importantly, to require insured credit unions to replenish the fund as well. If NCUSIF's ratio of reserves to insured funds should ever decrease to a level below 1.00 percent, credit unions would be required not only to write off those expended funds, but also restore the fund to a 1.00 percent level at that time.

Thus, the current system employed by NCUSIF not only insures that a FSLIC-type crisis will not occur at our nation's credit unions, but it further guarantees that the NCUSIF will not suffer a decline in capital to the extent that the FDIC is currently experiencing. However, it is very important to bring to your attention that the likelihood of NCUSIF's reserves ratio dropping to a level as low as 1.00 percent is extremely remote.

NCUSIF: The Safest and Soundest of the Federal Deposit Insurers

Mr. Chairman, since its voluntary recapitalization by credit unions, the NCUSIF has been and is now the healthiest of the three federal insurance funds. To guarantee its continued success, the NCUSIF has three solid barriers to protect against NCUSIF's reserves to insured shares ratio dropping below 1.00 percent. The first barrier is the interest income which is earned off of the deposits held by the fund. In 1988, this amount equalled $133 million, an amount 3.3 times more than NCUSIF's annual loss average over the last five years of $40.2 million and 1.7 times more than NCUSIF's highest loss ever of $77 million in 1982, the worst economic year since the Great Depression. In 1989, NCUSIF interest income is expected to increase to perhaps as much as $160 million as a result of higher interest rates.

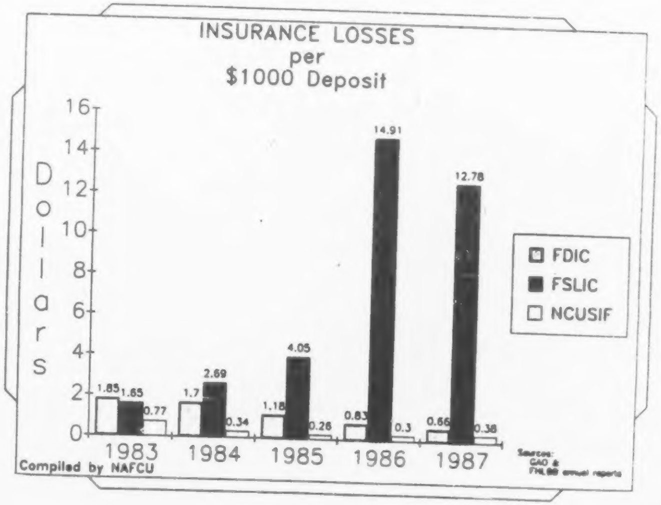
At this point, I would like to digress for a moment to address a misconception which some would have us accept as a truth -- that credit unions do not pay a dime for federal insurance. Nothing could be further from the truth. Not only did credit unions volunteer to keep one-percent of shares in Washington, D.C. -- an action which the president of the Americ Bankers Association said his members would vigorously object to if ever imposed upon banks, in response to a question asked during his testimony before the House Ways and Means Committee just last week -- but credit unions earn no interest on these funds whatsoever. If a credit union could earn more than 8 1/3 percent interest on these funds, which is today not a difficult undertaking, then a credit union in effect is paying a premium in excess of 1/12 of one percent for federal insurance.

There are those who, for reasons I cannot explain, ridicule the deposits in the NCUSIF as "funny money" or accuse credit unions of legerdemain in accounting for keeping these deposits on their books as an asset. Credit unions and the NCUSIF use generally accepted accounting practices, and maintaining these deposits on credit union books as an asset is entirely appropriate according to those accounting principles. Further, I can assure this committee that there was nothing funny about the $100 million dollars sent to the NCUSIF in January of this year by credit unions to bring their deposits up to the 1 percent threshold. The same holds true for the other $1.5 billion sent by credit unions to NCUSIF from 1985-1988. These are real dollars, not funny dollars, and each one of them contributes to decreasing the federal budget deficit.

The second barrier protecting NCUSIF is the NCUA's current statutory authority to assess and collect a premium equal to 1/12 of one percent of insured shares. Although this action has never been and is unlikely ever to be necessary, this premium would raise at least an additional $130 million, thereby nearly doubling the NCUSIF's income in any given year.

These two measures combined provide for more than sufficient coverage for any reasonably foreseeable loss to the NCUSIF. For example, these two measures would generate $275 million in 1989, an amount 3.6 times larger than the highest annual loss ever experienced by the NCUSIF in the depths of the 1982 recession, and 6.9 times greater than the average five year annual loss. It is important to note that even under such unprecedented circumstances, the NCUSIF's reserves-to-shares ratio would still stand at 1.25 percent, a level which FDIC someday aspires to attain. In order for NCUSIF's reserves-to-share ratio to drop to 1.00 percent, an additional $391 million in losses would be required to occur to hurdle the fund's third protective barrier -- the NCUSIF's total retained earnings. In 1989, for example, total NCUSIF losses would have to exceed $667 million -- or 8.6 times NCUSIF's worst annual loss ever, or 16.6 times the five year annual loss -- in order for the fund's reserve-to-share ratio to decline to 1.00 percent. To put it in even more graphic terms, in a single year the National Credit Union Share Insurance Fund would have to incur losses of $170.3 million greater than its total aggregate losses over its entire history from 1970 to today before the reserves-to-share ratio would dip below 1.00 percent.

These circumstances are, needless to say, highly unlikely. However, it is crucial to point out that NCUSIF already has a mechanism in place to guarantee that the fund would remain at 1.00 percent, compared to the current FDIC level of 0.83 percent. By contrast, if FDIC ever experienced losses of 8.6 times its 1987 loss or 16.6 times its 1983-1987 average, the fund would experience a deficit of between $8.1 and $13.6 billion! It is also important to note that while a record number of banks and savings and loans were closed by FDIC and FSLIC in 1988, NCUSIF also set a record for failed institutions -- a record low! Furthermore, as the chart below illustrates, the NCUSIF's loss ratio is historically much lower than either FDIC's or FSLIC's. This is because credit union assets are considerably less risky than those of their counterparts.



The point of these observations is to indicate that safeguards to protect the NCUSIF are more than sufficient, particularly when compared to the other federal deposit insurers. We are convinced that additional safeguards are not necessary at the current time nor will they be needed at anytime in the foreseeable future. However, even if there was a need to strengthen further the NCUSIF, the proposal contained in Title XI of S. 413 would not be desirable because, rather than improve the fund, it would inflict considerable harm to the continued safety and soundness of the NCUSIF.

NAFCU's Position

Mr. Chairman, the Administration's legislation addressing the nation's deposit insurance system has been coined by some as the "Never Let It Ever Happen Again Act of 1989." NAFCU is heartened to see steps being taken to resolve problems in the financial industry. But converting credit union deposits to government ownership and adding an expense burden to credit unions for eight years all in the name of efficiency, ease or "comparable accounting" -- while leaving the NCUSIF in a weakened position for the future -- just doesn't make sense. Title XI of S. 413 has no connection whatsoever with either the FDIC or FSLIC, or the serious depletions these funds have experienced. Contrary to the intent of this legislation, Title XI would only seriously hurt the insurance system Congress established just five years ago and raise the distinct possibility of Congress being required to redress this harm in the near future.

Title XI is not only ill-advised and injurious, but it is ironic as well. Title X of S. 413 mandates a study to investigate, among other things, how incentives for market discipline might be developed to minimize insurance fund losses, while the next title of S. 413 would eliminate the only successful system which already has in place precisely such incentives. If it is the intent of the Administration to seek uniformity, the nation's credit union community might suggest that NCUSIF's 1984 capitalization should be the model which FSLIC and FDIC should follow, not the other way around. Such action would be consistent with the recommendation contained in the GAO's recently released report, Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GAO/GGD-89-47). Specifically, the GAO states in that report, "We envision that recapitalization of the good...fund would be similar to the NCUSIF recapitalization under the Federal Credit Union Act amendment to the Omnibus Deficit Reduction Act of 1984." [See Appendix B]

We suggest this course of action for several reasons. First, the NCUSIF is the only fund which not only follows generally accepted accounting principles, but also makes a public monthly report as to its financial status and is audited annually by an independent outside accounting firm.

Second, the NCUSIF is the only fund that guarantees a capital level of 1.00 percent. This model -- if adopted by the other funds -- would most expediently return capitalization levels of FDIC and FSLIC to 1.25 percent.

Third, the NCUSIF is the only fund which has the ability to keep pace with the growth of insured savings. Further, the NCUSIF is the only fund where the financing burden is spread equitably among insured institutions, with those experiencing more rapid growth contributing proportionally greater sums to the insurance fund.

Fourth, the NCUSIF is the only fund which is designed to deal with both normal losses and catastrophic losses.

Lastly, the NCUSIF is the only fund that provides insured institutions with a strong market incentive to minimize insurance losses. Credit unions have a stake in minimizing their losses and the losses of other federally insured credit unions because excessive losses would result in not only more premiums, but restoration of their depleted NCUSIF deposits as well. This incentive should not be eliminated in the name of uniform accounting, particularly at the cost of the continued solvency of the NCUSIF.

Additional Provisions of S. 413

Mr. Chairman, there are two other areas addressed in S. 413 that I would like to focus upon briefly. The first has to do with enhanced enforcement authority for the National Credit Union Administration; the second has to do with the ability of NCUA to recruit and retain qualified examiners and staff.

NAFCU has been and remains committed to a regulatory system for credit unions which, to the best extent possible, guarantees the safety and soundness of all credit unions. As I have discussed at length, a sound and solid National Credit Union Share Insurance Fund is essential to such a plan. But the insurance fund can be most effective when the National Credit Union Administration Board has available to it tools necessary to engage in the proper supervision, regulation and examination of insured credit unions. Accordingly, we are generally supportive of the enhanced enforcement authority provided NCUA by this legislation. There are, however, specific provisions contained in Subtitle C of Title IX which we believe should be reviewed and revised. Specifically, we question both the need and the desirability of providing NCUA with the discretionary authority

to assess a penalty of up to $1 million per day on insured credit unions for violation of final orders. Sanctions clearly must be sufficient to induce compliance; however, we believe that an increase of the existing penalty from $1,000 to $25,000 for each day a violation continues should provide more than ample inducement to provide compliance. Penalties in the magnitude of $1 million a day are clearly inappropriate for credit unions, particularly in light of the fact that the average credit union is only $12 million in asset size.

As the members of this committee well understand, the National Credit Union Share Insurance Fund and its parent, the National Credit Union Administration, are both funded exclusively by the credit unions they insure and regulate. Not a single tax dollar has ever been used to assist in the funding or operations of either the NCUSIF or the NCUA. Against this backdrop, we believe the civil and criminal forfeiture provisions contained in Section 917 should be revised. The forfeiture provisions as presently constituted in Section 917 would allow any property taken or seized under forfeiture provisions to revert to the federal government, be liquidated, and funds generated by such liquidation deposited in the General Fund of the Treasury. Admittedly, such funds may be made available upon the order of the appropriate financial regulator to the financial institution which has a meritorious claim to those funds. Nevertheless, it seems only appropriate that such restitution ought be made to the institution as a matter of right and the cost by the financial regulatory agency should be repaid from the fruits of the forfeiture.

In regard to NCUA's ability to recruit and retain qualified examiners and support staff: the National Association of Federal Credit Unions strongly recommends to this committee that it extend to the National Credit Union Administration those provisions contained in S. 413 which, if enacted into law, would permit the Comptroller of the Currency to establish compensation levels for employees of that office, provided such compensation shall be generally comparable with that of the other federal financial regulators. The failure to give NCUA such comparable authority could have a serious negative impact on NCUA's recruitment potential, as well as a crippling effect upon staff morale and the ability to retain competent staff. I would ask the committee to view favorably this recommendation, recognizing once again that no tax dollars are used in the compensation of NCUA employees. Rather, such funds are derived by the agency from the credit unions it regulates, supervises and insures. Therefore, favorable action by this committee would be deemed appropriate, particularly since such action would not have any negative budgetary impact.

Conclusion

Mr. Chairman, there is an old saying that if something isn't broke, then don't fix it. Today, our message is a corollary to that rule: five years ago with your help and support we fixed the NCUSIF. In this year of 1989, let's not break it.

Thank you.

Appendix A

Senate consideration of legislation to recapitalize the National Credit Union Share Insurance Fund, May 1984.

CREDIT UNION PROVISIONS OF LEADERSHIP AMENDMENT NO. 3027, AS AMENDED, TO OMNIBUS DEFICIT REDUCTION ACT OF 1984

(Through inadvertence the following statements were omitted from the RECORD of yesterday. The statements will be printed in the permanent RECORD of May 17, 1984, prior to the vote on amendment No. 3027, as amended.)

IN SUPPORT OF CREDIT UNION PROVISIONS OF LEADERSHIP AMENDMENT

Mr. GARN. Mr. President, as chairman of the Banking Committee, I rise today in support of the amendment offered by the leadership, which contains language identical to S. 2522, a bill which deals with credit unions, their central liquidity facility, and the insurance of their members' share accounts. The bill was polled unanimously out of the Banking Committee and reported to the full Senate on April 2, 1984. It is a combination of two bills which Senator PROXIMIRE and I introduced on November 17, 1983, numbered S. 2120 and S. 2121; and of S. 2122, which I also introduced on that date.

The bill as reported provides for a large increase in the funding of the national credit union share insurance fund, (NCUSIF) with a corresponding decrease in the Federal deficit, exempts the NCUA's central liquidity fund from Federal, State and local taxation, and eliminates the fee imposed by the Treasury Department on financial institutions which receive payroll deductions from Federal employees. The measures have been revised to a minor extent since they were introduced.

These proposals were the subject of Banking Committee testimony by the Credit Union National Association (CUNA) and the National Association of Federal Credit Unions (NAFCU) on February 28, 1984, and by Chairman Callahan of the NCUA during the Banking Committee's banking deregulation hearing on March 21, 1984. The bill as reported has the support of the above organizations and the Treasury Department, all of which have been very helpful in moving the legislation forward. I understand that Chairman ST GERMAIN and ranking member WYLIE of the House Banking Committee are supportive of the measures contained in the bill. Moreover, Congresswoman MARY ROSE OAKAR introduced H.R. 3874, which exactly parallels the fee allotment language in S. 2522, and was instrumental in the House's passage of H.R. 3874. H.R. 3874 has been sent to the Senate and remains on the Senate Calendar.

I must also express my thanks to Chairman DOLE of the Finance Committee for his favorable consideration of my recommendation that a Finance Committee proposal to tax credit unions, estimated to gain $300 million in revenues over the next 3 years, not be pursued in light of the $1 billion contribution to the Federal Treasury that credit unions will make in a shorter period and in no event in more than 3 years, under the provisions of the NCUSIF recapitalization plan in this bill.

The following is a description of the three components of the bill:

1. TAX EXEMPT STATUS FOR THE CLF

Established in 1978 by Public Law 95-630, the Financial Institutions Regulation and Interest Rate Congrol Act, the CLF is the "central bank" for credit unions. The CLF is a mixed ownership corporation (stock owned by credit unions), is on-budget and is located within and managed by the NCUA. The bill would correct an oversight in the enactment of P.L. 95-630 which provided that the CLF be similar to Federal Reserve Banks and Federal Home Loan Banks but did not explicitly exempt the CLF from taxation.

For the past few years, the CLF pursued a tax exemption directly from the IRS and in October of last year received a ruling denying the request and stating that specific legislation was necessary to correct the situation. During the past four years, the CLF has made payments of $1.3 million to the IRS, with the bulk of the taxes, $1.1 million, incurred in 1983. In addition to the inequity of taxing one federal liquidity facility and not taxing other similar governmental entities, the result is that reserves and individual earnings of the CLF suffer.

This past month, twenty-nine corporate central credit unions joined the CLF, contributing capital of over $200 million to the CLF. With this addition, more than 18,000 credit unions (approximately 90 percent of all credit unions) will have access to CLF financing. With enactment of the bill as reported, credit unions and their members can be assured that the CLF will continue to be able to increase its capital and reserve accounts.

2. RECAPITALIZATION OF NCUSIF

The bill would increase the capitalization of NCUSIF by authorizing NCUA to impose a capital assessment on insured credit unions equal to 1 percent of their insured share accounts. The NCUSIF currently has approximately $250 million in capital, equal to 0.3 percent of insured shares, whereas its statutory normal operating capital level is set at 1 percent. The FDIC and FSLIC funds are both funded at about 1.3 percent of insured deposits.

CBO estimates that the NCUSIF proposal, in fiscal year 1985, would increase its capital to $1.25 billion through credit union capital transfers of $1 billion. (This assumes a growth rate in insured shares of 10 percent per year over the next 18 months). This would bring NCUSIF up to an appropriate capital level which is comparable to that of the FDIC and FSLIC.

Under the present system, NCUA increases NCUSIF's capital through undivided earnings and reserve accounts. Revenue to accomplish this, as well as to operate the fund, flows from annual premiums charged to credit unions. Because of the rapid growth in credit union insured deposits in the past two years (19 percent in 1982 and 18 percent in 1983), NCUA has charged a double insurance premium, equal to 1/6 of 1 percent of a credit union's insured shares; but since this has not increased NCUSIF capital enough (NCUSIF's equity/insured shares ratio has been between .25 percent and .32 percent for the past 5 years), NCUA developed the recapitalization plan to assure itself and credit unions of the stability and soundness of NCUSIF.

Under the 1 percent capital contribution program, credit unions would be required to deposit 1 percent of their insured shares and maintain that percentage permanently. With its existing equity, NCUSIF's capital would total 1.3 percent. If the total insured shares dropped, NCUA would decrease the deposit and, if NCUSIF's equity exceeds the 1.3 percent level in any year, distribute the excess to credit unions. The capital contribution would be refundable to credit unions upon leaving NCUSIF. NCUA would have the authority to phase-in the 1 percent transfer and it is expected that it will consider such a course in order to accomodate the specific financial needs of many credit unions.

While the recapitalization plan would require credit unions to sell liquid asset, the overwhelming majority support this proposal. Both CUNA and NAFCU have expressed their support for it. The major concern expressed has been that there be a phasein and, as indicated above, there is language in the bill authorizing that. In addition, in response to suggestions from credit unions, NCUA recommended that minor revisions be made to S. 2121 to assure credit unions that, if the recapitalization plan is adopted, there would be no double insurance premium, the 1 percent capital deposit would be refunded if NCUSIF is ever transferred out of NCUA, the liquidation payout priority provision affecting state laws be eliminated, NCUA would be required to submit an annual audited report to Congress regarding NCUSIF's operating level, and the title of the bill reflect that credit unions themselves are strengthening NCUSIF. These revisions have been made in the reported bill.

Another reason why NCUSIF's capital (.3 percent) is low relative to the FDIC and FSLIC (both approximately 1.3 percent) is that the FDIC and FSLIC each received initial capital from the Treasury Department. Thus, NCUSIF began in 1971 and has continued with premiums and investment income as the underlying sources of increased equity.

3. ELIMINATION OF TREASURY CHARGES OF PAYROLL ALLOTMENTS OF CIVILIAN FEDERAL EMPLOYEES

The bill would end the present fee of 6¢ per transaction which Treasury charges finanical institutions for depositing payroll allotments of civilian federal employees. The fee is not charged for federal military employees or for civilian employees overseas. Treasury supports this provision because the fee brings in less, approximately $2 million, than its costs to collect, about $4 million. Thus, in addition to removing a fee imposed on only certain federal employees, this proposal would save the government $2 million. This part of the bill is not controversial and all financial institutions support it. Moreover, the House passed the bill in 1982, although the Senate did not, and the House passed a similar bill, H.R. 3874, within the past few weeks.

4. BUDGET EFFECTS

The $1 billion being transferred by credit unions to NCUA to recapitalize the NCUSIF would, for budget purposes, be counted as reducing the federal deficit by a like amount (primarily because all NCUSIF funds are maintained in an account with the Treasury Department). (In addition to the $1 billion, it should also be noted that the $200 million which credit unions contributed to the CLF this past February also counts as a deficit reduction). If credit unions deposit growth continues, this amount would increase annually as credit unions maintain their 1 percent capital investment in NCUSIF.

The CLF tax exemption would result in $1.3 million in taxes already paid being refunded to the CLF. The effect of the refund would be to transfer the 1.3 million from the general Treasury to the CLF capital account at Treasury. CBO estimates that the refund would have no net budget impact.

The allotment fee elimination would result in an annual operating cost savings to Treasury of about $2 million. (This figure would increase if institutions, benefiting from the elimination of the fee, encourage more federal employees to use the direct deposit payroll system.)

With the relatively minor impact of the CLF and allotment fee issues included, CBO estimates that the overall impact of the bill would be a deficit reduction of $1 billion.

Mr. RIEGLE. Mr. President, I am pleased to rise in support of S. 2522. In my estimation, it is a reasonable and well thoughout approach to the needs of credit unions—that segment of the financial industry which remains dedicated to its tradition of providing credit through cooperative saving.

The three components of this bill address specific issues which, once resolved, will help stabilize and enhance the operation of credit unions throughout this country.

The first and perhaps most salient aspect of S. 2522 establishes a plan to strengthen the National Credit Union Share Insurance Fund, the fund through which the accounts of each credit union shareholder are protected up to $100,000.

Mr. President, those of us who serve on the Banking Committee appreciate those unique characteristics of credit unions which distinguish them from other institutions in the financial services industry. The National Credit Union Share Insurance Fund is one example of that distinctive difference.

Unlike the other deposit insurance funds, the credit union fund received no initial capitalization from the Federal Government. It is capitalized through premiums paid into it by participating credit unions and managed by the National Credit Union Administration (NCUA).

In 1982 expenditures of the fund exceeded income for the first time in its history. Although the fund was not jeopardized and the situation was temporarily alleviated by additional premium payments in 1982 and again in 1983, the condition pointed out the need for a more permanent funding arrangement.

The first provision of this bill represents that remedy.

I find it significant that this plan came to the Banking Committee by way of the credit unions. It is a responsible action designed to prevent a possible disruption to the fund by those credit unions who voluntarily participate to safeguard the accounts of their members.

In addition to raising the equity of the fund to 1.3 percent, the plan will improve credit union management by eliminating the burden of unpredictable double premium payments. Under this legislation, all insured credit unions will be required to maintain a 1-percent deposit in the share insurance fund. However, in recognition of the fact that credit unions have recently weathered one of the more stormy periods in their history, the NCUA Board has been granted the authority to extend the initial deposit period to avoid any adverse consequences.

This portion of the bill is responsive to the needs of credit union members as it strengthens the insurance fund. Yet, it is also cognizant of the condition of credit unions themselves by allowing the NCUA to tailor the initial participation period to the needs of each. Mr. President, as a member of the Banking Committee, which unanimously reported this bill to the floor, I commend the authors of this bill, Senators GARN and PROXMIRE, for their foresight in affording NCUA the flexibility to phase in the 1-percent deposit. I urge NCUA to use this authority freely. It is our intent that the 1-percent deposit be phased in so as to avoid undue or unnecessary hardship for the affected credit unions.

The second major provision of S. 2522 is one which clarifies the tax status of the Central Liquidity Facility (CLF).

In many respects, the CLF is to credit unions what the Fed is to banks. It is a source of favorable financing available for the short-term needs of credit unions. Unlike its counterpart, however, the CLF was inadvertently overlooked in tax legislation providing exemptions to this type of corporation. As a result, the CLF has accumulated a tax bill which the IRS is now looking to collect.

The retroactive effective date contained in S. 2522 will correct this discrepancy and will allow the CLF to operate free of tax liability as was the original intention when the corporation was constituted.

The final provision of S. 2522 removes the fees charged by the Treasury to financial institutions which receive payroll allotments for Federal employees. Eliminating this fee will improve government efficiency and will aid the Department of the Treasury in making full use of electronic fund transfer.

Mr. President, each of the provisions of this bill are well considered and will effect changes which will fortify all credit unions. I know of no significant opposition to this legislation and urge its immediate passage.

Mr. D'AMATO. Mr. President, I rise in support of S. 2522.

Many in this Chamber are aware that this year is the 50th anniversary of the signing of the Federal Credit Union Act. As we mark a half century of existence for Federal credit unions, it is significant that we are called upon today to consider legislation which will authorize a plan to increase the equity of the National Credit Union Share Insurance Fund.

The Federal Credit Union Act made the nationalization of credit unions a reality. Instead of being restrained in their service by State charter, the act gave credit unions the authority to follow the common bond of their membership across State lines. With this freedom, Federal credit unions have been able to provide services to their members throughout the world.

Today, 50 years after the enactment of that landmark legislation, we are being called upon to approve another credit union bill. Although S. 2522 does not possess the profound characteristics of the National Credit Union Act, it does contain several provisions of significance to Federal credit unions and their members. It is likely that this legislation will substantially effect the operations of credit unions during the next 50 years.

Clearly, the most significant aspect of S. 2522 is the positive impact it will have on the National Credit Union Share Insurance Fund.

The Fund, which is managed by the National Credit Union Administration (NCUA), is unique from other federally administered deposit insurance funds such as those of the FDIC or the FSLIC in that it received no initial capitalization from the Federal Government. Revenue for the Fund is currently obtained from the contributions of participating credit unions. Yet, similar to the deposit insurance provided at other financial institutions, the National Credit Union Share Insurance Fund guarantees the accounts of credit union members up to $100,000.

S. 2522 contains provisons which will strengthen the fund. Instead of relying upon periodic premium payments as a source of capitalization, this bill requires all insured credit unions to maintain a 1.0-percent deposit in the share insurance fund. This plan will raise the equity level to 1.3 percent, a level comparable to that of the other federally administered deposit insurance funds.

Mr. President, I feel a point here deserves emphasis. The National Credit Union Share Insurance Fund was started by credit unions to insure the accounts of their members. Although it is administered by the National Credit Union Administration, no Federal funding has been involved. The plan embodied in S. 2522 came to the Banking Committee as a proposal from credit unions themselves, motivated by an interest to raise the equity level of the fund.

Like many financial institutions, credit unions have recently been through a difficult period. Perhaps the proposal to strengthen their insurance fund is reflective of that experience. It was certainly something the Banking Committee recalled as it considered this legislation.

In S. 2522, regarding the capitalization of the insurance fund, there is a provision authorizing the NCUA Board to extend the initial time period in which credit unions would have to place 1.0 percent of their deposits in reserves. It is the clear intent of this provision that the 1.0 percent deposit be phased-in where necessary; any other arrangement might result in hardship for the affected credit unions. I would commend NCUA to take note of this provision and anticipate to use its authority freely.

Just as we must remain responsive to the needs of credit union members by legislating a plan which will bring stability to their insurance fund, we should also direct the Agency administering this fund that no precipitous steps should be taken to achieve the 1.3 percent equity level if an alternative plan is available which will alleviate any difficulty for the credit unions themselves.

Mr. President, as a member of the Banking Committee, I commend Senators GARN and PROXMIRE for their diligent work on this bill. It is responsive to the needs of both credit unions and their members.

This bill was unanimously approved by the Banking Committee, and I hope the full Senate will take similar action.

Mr. CRANSTON. Mr. President, I rise in support of the leadership's amendment containing identical language to S. 2522.

This is a good piece of legislation because it will improve the future stability of the National Credit Union Share Insurance Fund—the Fund which insures the accounts of credit union members up to $100,000.

As a member of the Banking Committee, I must commend the chairman, Senator GARN, and the ranking minority member, Senator PROXMIRE, for their efforts in bringing this amendment to the floor. In my opinion, S. 2522 is characterized by foresight and realistic good judgment.

The amendment is forward thinking in that it proposes a plan to bring permanent stability to the Share Insurance Fund without the prompting of a crisis situation. Under the present arrangement, the Fund is capitalized by periodic contributions from participating credit unions. Although the Share Insurance Fund is administered by the National Credit Union Administration (NCUA), it receives no funding from the Federal Government. During recent years, demands upon the Fund have necessitated that the NCUA levy double premium payments upon member credit unions. Instead of continued reliance on an increasingly irregular system of periodic payments, this bill requires all insured credit unions to maintain a 1-percent deposit in the Share Insurance Fund. As a result, the equity level of the Fund will be increased to 1.3 percent, which is comparable to that of the other federally administered deposit insurance funds.

S. 2522 is also characterized by a quality of good judgment. As those of us who follow the financial industry know, credit unions have recently been through some trying times. For this reason, some do not as yet possess the capital liquidity necessary to immediately deposit 1-percent of their assets into the Share Insurance Fund. The amendment before us has included a provision that will enable the NCUA to accommodate credit unions which might have difficulty meeting a 1-percent deposit requirement. It is the clear intent of this bill that the 1-percent deposit be phased in over an extended period of time where necessary. The NCUA should not hesitate to use this authority.

Mr. President, this amendment is responsive to the needs of credit unions and most importantly responsive to the concerns of their members. I urge the Senate to vote favorably.

Mr. GARN. Mr. President, the Banking Committee reported S. 2522 on April 2, 1984, dealing with recapitalization of the credit union share insurance fund. I thought it would be useful to include in the RECORD comments supportive of the plan which I have received in the last few months from two associations for credit unions, the National Association of Federal Credit Unions (NAFCU), and Credit Union National Association (CUNA). I ask unanimous consent that these letters from those two associations be printed in the RECORD in full.

There being no objection, the letters were ordered to be printed in the RECORD, as follows:

CREDIT UNION NATIONAL
ASSOCIATION, INC.,
Washington, D.C., February 28, 1984.

Hon. JAKE GARN,
U.S. Senate,
Washington, D.C.

DEAR SENATOR GARN: This letter has two purposes: (1) to thank you for recommending to Senator Dole that the Senate Finance Committee not consider taxing credit unions at this time and (2) to reiterate that with the changes in S. 2121 that you announced today CUNA unreservedly endorses this legislation and supports your efforts to assure its prompt passage.

Enactment of S. 2121, the bill to capitalize the Share Insurance Fund, is a priority matter for the credit union movement, which has been discussing how best to meet its long-term capital needs for nearly five years. CUNA formed the National Credit Union System Capitalization Commission for this purpose in 1981. In April, 1982, the National Credit Union Administration, after lengthy consultation with credit unions, formally adopted a policy goal of raising the equity of the Share Insurance Fund to the 1% operating level set by Congress. CUNA, too, endorsed this goal and thereafter set about studying plans for its attainment, including the one detailed in S. 2121. CUNA sent its 17,898 affiliated federal and state chartered credit unions a special background paper explaining the legislative proposal. It was examined at league and chapter meetings and discussed with the more than 1,000 credit union executives who attended CUNA's recent Governmental Affairs Conference.

NCUA also devoted its resources to making certain that credit unions understood the proposal and had ample opportunity to comment upon it. The agency produced a video tape on the plan and sent it to all 50 credit union leagues, trade groups, its six regional offices, its examination force and any credit union that requested a copy. In addition, the agency mailed the managers and boards of all federally insured credit unions a letter requesting that they verify the plan's impact on their individual credit union's balance sheet. Over 1,800 credit unions responded to this mailing, and the overwhelming majority endorsed the plan.

This review is meant to underscore that the capitalization plan has been thoroughly discussed with credit unions and that it has broad based support at the grassroots level as well as among credit union leadership. We hope that Congress will enact S. 2121 quickly so that credit unions can get about the business of putting the capitalization plan into operation.

Yours sincerely,

HAROLD T. (TOM) WELSH,
Chairman.

NATIONAL ASSOCIATION OF
FEDERAL CREDIT UNIONS,
Washington, D.C., March 19, 1984.

Hon. JAKE GARN,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: During testimony on S. 2121 before your Committee on February 28, 1984, I reported that the National Association of Federal Credit Unions was surveying membership as to their desires, concerns or recommended position on this important legislative proposal. You commented that day that you hoped we would continue to review proposed changes with our membership and "communicate to the Committee what their feelings are."

We are satisfied at this time that sufficient membership response has been received to give us a positive position on the bill. NAFCU's membership supports the capitalization of the share insurance fund as proposed in S. 2121. There is enough concern expressed by our members, however, for the NAFCU Board of Directors to ask for a phase-in of the capitalization. This would allow time for credit unions to liquidate or adjust investments and to plan their cash flow to provide the amount required to further capitalize the NCUSIF.

Fortunately, S. 2121 includes a provision for a phase in. It states:

"The Board (NCUA) may, in its discretion, authorize insured credit unions to initially fund such deposits over a period of time in excess of one year, if necessary to avoid adverse effects on the condition of the credit union."

NAFCU's Board, acting for its membership, asks for a three-year phase-in for all credit unions. Such an arrangement would infuse approximately $270 million in new capital into the NCUSIF in each of the next three years. This would reach the goal of capitalizing the fund at 1.0% of insured shares above the present equity of 0.3% of insured shares in a manner less burdensome than would be a single deposit. At the same time, credit unions would help to reduce the federal deficit each year at a rate nearly three times the amount anticipated in recent proposals to tax credit unions.

We are pleased to support the legislation that will make the NCUSIF stronger than ever. We applaud NCUA for developing this bold and straightforward plan. We also thank you, Mr. Chairman, for your continuous interest in a strong credit union system in the United States. Your foresight in offering S. 2121 at this time is commendable.

NAFCU stands ready to offer all assistance we can to see that S. 2121 becomes law of the land with those conditions we have asked for being fully considered.

Sincerely,

JOHN J. HUTCHINSON,
President.

Appendix B

Excerpt from a GAO report entitled "Troubled Financial Institutions, Solutions to the Thrift Industry Problem".

Recapitalization of the National Credit Union Share Insurance Fund

Our report discusses a good company/bad company merger of FSLIC and FDIC. We envision that recapitalization of the good company fund would be similar to the NCUSIF recapitalization under the Federal Credit Union Act amendment to the Omnibus Deficit Reductions Act of 1984 (Public Law 98-369). This appendix explains the key provisions of the NCUSIF arrangement and discusses briefly how the NCUSIF plan has worked thus far.

The NCUSIF Recapitalization

During the 1970s NCUSIF was funded primarily by annual premium assessments, from which it had built capital and reserves to 0.3 percent of insured shares in 1979—a level below the 1 percent level prescribed in the Federal Credit Union Act. Beginning in the late 1970s, NCUSIF faced financial problems because economic fluctuations, poor investments, and stiffer competition had caused a number of credit unions to fail. Reserve levels fell and remained below 0.3 percent through 1983 in spite of a special premium assessment which increased assessment income by 67 percent in 1982 and by 100 percent in 1983.

The Federal Credit Union Act amendment to the Omnibus Deficit Reduction Act of 1984 provided that a credit union applying for federal insurance would pay and maintain a deposit of 1 percent of the value of insured shares (deposits) with the insurance fund. The act also provided that the normal operating level for NCUSIF reserves would be determined by the NCUA Board. The Board has thus far set it at the maximum level prescribed in the act—1.3 percent of insured deposits. The act also provided that credit unions would pay annual premiums of 1/12 of 1 percent if required by the NCUA Board to maintain the normal operating level after payment of insurance expenses. If reserves exceed the normal operating level, the Board could waive the subsequent insurance premium, rebate the previous premium, or distribute the excess amount to the credit unions as a dividend.

The NCUSIF plan had two key features. First, the 1-percent deposit is carried on each credit union's books as an asset and is fully refundable to the institution if insurance coverage is terminated, other insurance coverage is obtained, or if NCUSIF operations are transferred from NCUA. The deposit is not refunded if the institution is liquidated due to insolvency or bankruptcy. Like any asset, the deposit can be carried at full value so long as its value is not materially impaired. Therefore, so long as the insurance fund is not experiencing losses so large that it must use the 1-percent deposit to pay expenses, the cost to the credit unions of financing the insurance fund is equal to the net effect of the following items.

foregone income that could have been earned by investing the 1-percent deposit in other ways, the premiums avoided, and any dividend rebated by the insurance fund.

The second key feature of the NCUSIF plan is that the contribution by the credit unions was considered a revenue item for the fund and a revenue item for federal budget purposes primarily because all NCUSIF funds are maintained in an account with Treasury. Thus, when NCUSIF was recapitalized, the initial deposit resulted in a credit of $844 million[1] which was treated as revenue, thereby reducing the federal deficit and offsetting the deficit-increasing effect of expenditures on case resolutions.

Experience Under the Recapitalization Plan

The NCUSIF recapitalization seems to have worked well. NCUSIF reached its target operating level in the first year while simultaneously acting to resolve problem cases. The credit unions have not had to pay an annual insurance premium since the recapitalization—avoiding $387 million in premiums over the 1985-1988 period. (A 1-year waiver equals about an 8.3 percent dividend on the credit unions' 1-percent contribution.) The credit unions' investment in NCUSIF has not been at risk, so credit unions have been able to carry their contribution as a fully valued investment asset. From a federal budget perspective, NCUSIF recapitalization increased the government's net receipts over $800 million in 1985 and about $100 million in 1986.

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[1] The credit union actual payment was $760 million. The remainder of the $844 million represented the value of the premium waiver and a dividend for 1985 which were credited as part of the capital contribution.

The CHAIRMAN. Thank you, Mr. Robinson.

Senator Pressler has joined us. Senator Shelby has joined us. Senator Pressler, did you have an opening comment that you wanted to make before we go to Mr. Williams?

Senator PRESSLER. No, I do not, Mr. Chairman. I apologize. I've got three committees meeting simultaneously.

The CHAIRMAN. Senator Shelby, I think we have an Alabamian at the table.

Senator SHELBY. Mr. Chairman, I know you've already introduced Mr. Williams, but since he's from Alabama, would you permit me to say a couple of things about him?

The CHAIRMAN. Please do.

Senator SHELBY. It's my pleasure to introduce you to the committee again, Mr. Williams.

Mr. Williams is chairman of the Credit Union National Association, which is the largest trade association representing the credit unions in this country.

Mr. Williams also happens to be the manager of the Listerhill Employees Credit Union in Sheffield, AL. He's been active in the credit union industry for over 20 years and I believe his experience will make him an informative and helpful witness here today and on behalf of the Banking Committee I welcome you to the committee and look forward to your testimony.

Mr. WILLIAMS. Thank you, Senator Shelby.

STATEMENT OF AL WILLIAMS, CHAIRMAN, CREDIT UNION NATIONAL ASSOCIATION AND AFFILIATES, ACCOMPANIED BY RALPH S. SWOBODA, PRESIDENT, CREDIT UNION NATIONAL ASSOCIATION, INC.

Mr. WILLIAMS. Mr. Chairman and members of the committee, my name is Al Williams and I am the manager of Listerhill Employees Credit Union from Sheffield, AL. Our credit union serves 29,000 members, including all of the workers at Reynolds Metal Co. in Sheffield.

I am here today as chairman of the Credit Union National Association and Affiliates. As stated earlier, we do represent 91 percent of our Nation's 15,800 credit unions and their 60 million members.

Accompanying me today is Mr. Ralph Swoboda, the president of CUNA.

As you know, credit unions are nonprofit, member-owned financial cooperatives and are quite small. At the end of 1987 credit unions averaged only $11 million in assets, compared to the average bank of $230 million, an average S&L of $385 million. Our total assets are but 3.7 percent of the assets of all depository institutions.

Credit unions fully understand the magnitude of the financial problem facing our country and the urgency for you to move this legislation to address the savings and loan crisis.

In fact, had not the credit union deposit insurance provisions been added at the last moment, we would not have requested your valuable time this morning. However, once the magnitude and implications of writing off the one percent deposit in the National Credit Union Share Insurance Fund and reverting to the old premium system became understood across the credit union community, we had no choice but to come here with our concerns.

I have been in the credit union movement for 20 years and I have never seen credit union managers, officials, and members this dismayed. They simply cannot believe what is happening to them.

The credit union provision before you is being portrayed by Treasury as making a technical accounting change to the Share Insurance Fund by requiring "comparable" accounting procedures for all funds. While at first glance this may appear harmless, one credit union director remarked, "So was the Kool-Aid prepared by Jim Jones." In our judgment, what ought to be done is to make the other two funds "comparable" to the credit union fund. The National Credit Union Share Insurance Fund works. This fund has the highest equity level of the three funds.

In his testimony before the committee, the Secretary of Treasury explained the fund changes as being necessary to strengthen the fund and because credit unions will resist any experience of the 1 percent deposit.

Basically, Mr. Chairman, we are saddled with unsubstantiated claims that our fund is unstable and an accusation that we would lobby against the plan which we otherwise put together.

We strongly disagree with the Secretary's assessments of our commitment to our own fund.

Let me quickly review overall credit union health. Credit unions have come through the stress of the past decade with flying colors. In sharp contrast to other financial institutions, as a group credit unions are stronger now than they were at the beginning of the decade.

The overall capital ratio at the beginning of the decade was 6.5 percent and currently it stands in excess of 7 percent. Credit unions' balance sheet show that they are protected from undue risk. Credit union sources of funds are almost entirely made up of retail deposits, not highly rate-sensitive commercial or brokered deposits.

The assets side of the credit union balance sheet is also safe and stable. Unlike S&L's, credit unions have only a small portion of their assets in long-term fixed-rate mortgages and credit unions have virtually no real estate development loans. Unlike commercial banks, credit unions have had almost no business loans into depressed sectors of the economy such as energy and agriculture, to developing countries, or to firms involved in leveraged buyouts.

Credit unions' cooperative structure also keeps us safe. The moral hazards of deposit insurance in which undue risks are taken because the insurance fund picks up failed gambles doesn't apply to credit unions. This is because the credit unions are owned and controlled by its members, not just a few.

Let me now briefly review the history of the deposit insurance. The insurance developed in 1930 was a requirement for all federally-chartered banks and S&L's. But at that time Congress decided that the Federal credit unions could operate on an uninsured basis by relying primarily on State stabilization funds. This lasted until 1970.

After a lengthy debate among the credit unions in the United States, we sought and received legislation to establish a Federal fund. But unlike the FDIC and the FSLIC, no Government start-up money was requested and none was provided.

In 1984, credit unions, their regulator, and Congress worked together to modernize the fund using a deposit base. In January 1985, credit unions mailed to the National Credit Union Administration an amount equal to 1 percent of their insured savings. Put another way, it was an amount equal to 12 annual premiums to be placed as a deposit in the fund.

The Share Insurance Fund retains the income earned on these deposits. Each January, federally insured credit unions must forward to NCUA additional dollars to coincide with the 1 percent growth that they've had in the previous year.

If there are large losses at the Share Insurance Fund, the statute gives NCUA the additional authority to assess in any year another one-twelfth percent of 1 percent premium and to require the credit unions to expense or to write down a portion of the 1 percent that we have on deposit.

The Share Insurance Fund is deliberately structured as a pay-as-you-go fund in order to avoid the situations where problems are allowed to build up over the years.

I'd like now to address how the proposal weakens the National Credit Union Share Insurance Fund.

Mr. Chairman, the Treasury's accounting changes raises credit union deposit insurance costs 250 percent of what they are paying today. Further, it returns our fund to an old premium base. Ironically, this painful change would not contribute $1 to help the S&L crisis and would actually weaken our fund.

The Treasury proposal would replace the current system of a 1 percent deposit plus retained earnings with an 8-year write-down of the deposit and an annual premium of one-twelfth of 1 percent.

Because the current system requires credit unions to capitalize growth at 1 percent and because one-twelfth of 1 percent is .083 percent, the current system will provide a higher fund equity level than the Treasury proposal whenever annual savings growth exceeds 8.3 percent. Over the decades of the 1980's, the credit union growth annualized has been 13.5 percent and in the 1970's it was 15.5 percent. Since these growth rates substantially exceed 8.3 percent, had the Treasury proposal been in effect for some time, the share insurance ratio of the fund balance to insured savings, the covered ratio would be well below its current level of 1.25 percent.

In my written statement I list the cost increase components of the Treasury plan. When these costs are added together and adjusted for average credit union growth, the cost to the credit unions will be slightly over 2.5 times the premium, a lot more than the banks and the S&L's are asked to pay.

Mr. Chairman, my testimony on pages 9 and 12 shows how well our fund is presently structured to meet catastrophes, especially when compared to the premium-based FDIC.

I stated earlier that there is dismay and disbelief spreading throughout the credit union movement over the dramatic increase in the insurance costs. This distress is greatly magnified by the growing accusation that our system is unsafe. Credit unions are reading in newspapers all around the country that the banking officials are concerned about credit union capital growth and regulatory structure. These officials were blatant in unsubstantiated comparisons to the S&L situation. Immediately after the release of the plan, CUNA began receiving press and congressional inquiries about the safety and soundness of the credit union movement. For 2 years the country has been in the middle of a financial crisis and during that time we had virtually no inquiries about a credit union crisis. Suddenly we are confronting a growing anxiety about the soundness of our insurance fund and this is in spite of our extremely good health. Credit union officials are beginning to suspect that amidst the excitement, confusion and urgency of resolving the S&L crisis, the bankers—particularly the small, independent ones—are deliberately sowing doubt concerning credit union capital, regulations, insurance, growth and overall safety and soundness.

Mr. Chairman, we are concerned that because of the adamant opposition to this provision some are portraying credit unions as not wanting to do their fair share in the national crisis.

First, we believe that developing and maintaining as healthy a sector of the financial community as we can should not be overlooked.

Second, we fail to see where the banks are contributing anything themselves to resolving the S&L crisis. They are simply increasing their payments to their own deposit insurance fund to prevent the ratio from falling any further. We have already gone through the pain of doing this in 1985.

If this Congress determines that across-the-board different sacrifices are required, we would certainly be willing to participate in developing such solutions. Often, we are left out of the planning sessions and across-the-board solutions fail to recognize the credit union differences and, therefore, cause severe, unintended disruptions in the credit union system. Today's situation is a classic example.

In addition to requesting that our fund remain intact, my written statement requests certain refinements to the enforcement powers to the regulators.

Mr. Chairman, that completes my oral statement and I would be glad to answer any questions.

[The complete prepared statement of Al Williams follows:]

STATEMENT OF

AL WILLIAMS

ON BEHALF OF

CREDIT UNION NATIONAL ASSOCIATION AND AFFILIATES

BEFORE THE

SENATE BANKING, HOUSING, AND URBAN AFFAIRS COMMITTEE

ON

S. 413

THE FINANCIAL INSTITUTIONS REFORM, RECOVERY
AND ENFORCEMENT ACT OF 1989

MARCH 15, 1989

Mr. Chairman, members of the panel, my name is Al Williams and I am the manager of the Listerhill Employees Credit Union located in Sheffield, Alabama. Our credit union serves 29,000 members, including almost all of the workers of the Reynolds Metal Company in Sheffield.

I am here today as the Chairman of the Credit Union National Association and Affiliates (CUNA). CUNA is organized around 50 state credit union leagues and leagues in the District of Columbia and Puerto Rico. Through our leagues we represent 91% of our nation's 15,800 credit unions --8,300 federal credit unions and 6,000 state credit unions --and their 60 million members.

Credit unions fully understand the magnitude of the financial problem facing our country, and the urgency for you to move this legislation to address the savings and loan crisis. We certainly do not want to contribute in any fashion to delaying the expedited schedule which Congress is trying to meet. We in the credit union movement think the President's plan is overall a very decisive and bold proposal designed to quickly come to grips with the crisis, and we pledge to cooperate with you whenever and wherever we can be of assistance.

In fact, had not the credit union deposit insurance provisions been added at the last moment, we would not have requested your valuable time today. However, once the magnitude and implications of writing off the 1% deposit in the National Credit Union Share Insurance Fund (NCUSIF) and reverting to the old premium system became understood across the credit union community, we had no choice but to come here with our concerns.

I have been in the credit union movement for over 20 years and I have never seen credit union managers, officials, and members this dismayed. They simply cannot believe what is happening to them. My phone is ringing off the hook as credit union folks all over the country are calling me wanting to know what I, as their chairman, am going to do about what appears to be a deliberate attempt to undermine not only their deposit insurance fund, but their safety and soundness, their reputations, and everything the credit union movement has worked so hard to achieve.

A typical example of this attack appeared in the Portland (Indiana) Forge on March 6 of this year. The chairman of Indiana United Bancorp is quoted as stating that "the same factors which led to the nation's crisis in the savings and loan industry exist today in the country's credit unions." Such inflammatory comments should be considered unconscionable in today's crisis environment and yet banking officials seem to be orchestrating a nation-wide effort to this effect.

The credit union provision before you is being portrayed by Treasury as making a technical accounting change to the Share Insurance Fund by requiring "comparable" accounting procedures for all funds. While at first glance this may appear innocuous, one credit union director remarked, "So was the Kool-Aid prepared by Jim Jones." In our judgment, what ought to be done is to make the other two funds "comparable" to the credit union fund. The National Credit Union Share Insurance Fund works. This Fund has the highest equity level of the three funds. There were far fewer credit union failures in 1988 than bank or savings and loan failures, and this was due in part to the structure of our insurance fund.

I. THE FINANCIAL HEALTH OF CREDIT UNIONS

Credit unions are non-profit, member-owned financial cooperatives. These democratically structured institutions are small by financial institution standards. As of the end of 1987, credit unions, on average, had $11 million in assets, while the average bank had $230 million and the average savings and loan $385 million. Credit unions assets, moreover, constitute a very small proportion--3.7%--of the assets of all depository institutions.

The past decade has been the most tumultuous period for U.S. financial institutions since the 1930's. The turmoil began with the deregulation that allowed financial institutions to actively compete with each other after forty years of public policy that protected depositors by limiting competition among institutions. Shortly after the beginning of deregulation, the Federal Reserve Board adopted a policy to stem the raging inflation of the late 1970's. That produced some of the highest and most volatile interest rates of history. Another consequence occured in the early 1980's with the most severe recession since the 1930's. Since then, the economy has seen financial collapses in energy and agriculture, and economic weakness in developing countries.

Credit unions have come through the stresses of the past decade with flying colors. In sharp contrast to other financial institutions, as a group credit unions are stronger now than they were at the beginning of the decade. The number of credit unions has declined since the onset of deregulation, from 22,200 in 1978 to 15,800 at the end of 1988. Almost all of the credit unions no longer in existence were tiny, and most of them merged with other larger credit unions to create stronger institutions which continue to offer credit union services to members of the merged institutions.

Capital Level Remains High in Credit Unions

The overall capital-to-asset ratio of credit unions has risen from 6.5% at the beginning of the decade to a level of 7.0%. Considering that the only source of capital to credit unions is earnings retention, and considering credit unions' strong growth of the 1980's, this increase in the capital ratio is remarkable. Also, the 7.0% figure is the ratio of total capital--reserves and undivided earnings--to total assets, not risk-adjusted assets. When computed on the basis of the risk-adjusted asset formula being put in place for commercial banks, credit unions' capital ratio would be even higher.

The relative health of the three types of depository institutions is shown in Table 1. The net capital-to-asset ratios (third column) of banks and credit unions are about the same, at near 6%. Credit unions have slightly lower total capital ratios than do banks, but also lower amounts of non-performing or delinquent loans, which are subtracted to arrive at the net capital ratio. The net capital ratio at S&L's is negative. The good health of credit unions themselves, coupled with the strong position of the NCUSIF, indicates that the current deposit insurance system for credit unions is on very stable footing and does not need revision.

Table 1
Relative Health of Financial Institutions
(Based on March-September 1988 Data)

	Equity Capital/ Assets	Delinquent Loans/ Assets	Net Capital/ Assets (Capital-Delinquent Loans)	Ratio of Federal Insurance Fund to Insured Deposits
CU's	7.0%	1.1%	5.9%	1.25%
Banks	8.0%	2.1%	5.9%	0.83%
S&L's	3.0%	3.9%	-0.9%	-5.00%

Structure and Operations Assure Credit Union Strength

There are two reasons behind the strong financial condition of credit unions. First, the organizational structure of credit unions as cooperatives provides little incentive or temptation to excessive risk taking. Second, credit unions operate as retail financial institutions allowing them to avoid the pitfalls that have recently plagued other financial institutions.

"Moral hazard" is a term used to define one of the inherent problems of a federal deposit insurance system. The problem arises when an entrepreneur can buy a federally insured financial institution with an amount of capital that is but a tiny fraction of the total assets of the institution. The owner can then attract deposits at low, risk-free interest rates--because of deposit insurance--and acquire much riskier and higher yielding assets. If all goes well, the owner gets a phenomenal return on the capital invested. If all does not go so well, the federal deposit insurance system is left to pick up the pieces. All the owner loses is his capital--small relative to total assets.

This theory of moral hazard goes a long way toward explaining the problems of Texas thrifts over the past several years. Note that moral hazard does not refer to fraud. It simply implies that the costs of legal risk taking are not borne by the risk taker. This leads to excessive risk taking.

By virtue of the cooperative structure of credit unions, moral hazard is not a problem faced by the credit union deposit insurance system. A credit union is owned equally by all of its members. It's one member, one vote -- not one dollar, one vote. Because the ownership of credit unions is so widely distributed over the membership, there is little incentive for owners or management to try to "swing for the fences." As a result, credit unions hardly ever "strike out."

Credit unions' balance sheets show how they are protected from undue risks. Credit unions' sources of funds are almost entirely made up of retail deposits--not large, highly rate sensitive commercial and brokered deposits. Although credit unions typically pay attractive rates on these savings, the funds are quite stable. Credit unions are not subject to substantial outflows of a few very large deposits because of slight changes in interest rates.

The asset side of credit union balance sheets is also safe and stable. Unlike S&L's, credit unions have only a small portion of their assets in long-term, fixed-rate mortgages, and credit unions have virtually no real estate development loans. Unlike commercial banks, credit unions have had almost no business loans to depressed sectors of the economy such as energy or agriculture, to developing countries, or to firms involved in leveraged buyouts. The most significant asset on credit union balance sheets is the consumer loan (about 43% of assets). These are small and short-term, and have a very low default rate--less than one half of one percent of outstanding loans per year. Because many credit unions remain closely aligned to specific employers, many credit union loans are repaid through payroll deduction plans. Investments make up another 35% of assets and are stricly limited by statute. These investments are held primarily in government securities or in deposits at federally insured institutions. Over three quarters of the investments mature in less than a year.

Mortgage loans of all types comprise about 18% of assets. About a third of this amount is in home equity and other shorter-term second mortgage loans. Only about 10% of credit union assets are in long-term, fixed-rate mortgages. Less than 1% of credit union assets are in business loans to members, typically small businesses. The balance of credit union assets are in cash and other miscellaneous assets (about 3%).

The organizational structure and safe balance sheets of credit unions explain why credit unions have come through the 1980's in such good condition. These two factors are also why we are confident that credit unions will remain healthy in the 1990's and why our type of deposit insurance system is best for us.

II. DEVELOPMENT OF CREDIT UNION SHARE INSURANCE

History of Share Insurance Until the 1980's

It is important that we briefly review the history of deposit insurance for credit unions which differs radically from the history of the FDIC and FSLIC. Following the banking crisis of the early 1930's, deposit insurance was made mandatory for federally chartered banks and S&Ls. Congress decided, however, that federal credit unions could operate on an uninsured basis by relying primarily on the various state stabilization funds. This continued until 1970. During that time, credit union liquidations occurred mostly due to plant closings, and members were given their share in the liquidated credit union in an orderly fashion. History shows that this system worked extremely well especially when you review the minimal number of complaints which members of Congress received in this 35-year period of no federal insurance. Incidentally, during this period several state level deposit insurance funds were started and operated quite successfully. In fact, it was in these state level "laboratories" that the creative concepts used to modernize our federal Fund in 1984 were developed.

In the late sixties and early seventies, financial institutions employed deposit insurance more and more as a marketing tool. Therefore, consumers were more attuned to look for its presence, or in our case, its absence. After lengthy debate, the credit union movement sought and received legislation to establish a federal Fund. Unlike the FDIC and FSLIC, no government start-up money for this fund was requested nor provided. When we look back, we see that our Share Insurance Fund operated during its first year with a grand total of assets equal to only 1/12 of 1% of credit union insured shares -- the first year's premium, a fact of no particular concern because we had funtioned for decades without federal insurance.

The original plan was to gradually build up the Share Insurance Fund to 1% of insured shares through the assessment of an annual 1/12 of 1% premium. This plan did systematically begin to build up the base of the Fund and it reached 0.3% of insured shares in 1979. Additionally, the Share Insurance Fund had the authority to assess a second premium in any given year, something that was not done during the 1970's.

Modernization and Recapitalization of the NCUSIF

In the early '80s credit union membership growth accelerated and economic recession increased the closure of credit unions. These factors prevented the Fund ratio from further growth. Double premiums were assessed in 1982 and 1983. Even so, the Fund's equity level just about held its own. Using the deposit concept piloted successfully at the state level, credit unions, their regulator, and Congress worked together to modernize the Fund in 1984.

In January 1985, credit unions mailed to the National Credit Union Administration (NCUA) an amount equal to 1% of their insured savings -- put another way, it was an amount equal to 12 annual premiums -- to be placed as a deposit in the Fund. The NCUSIF retains the income earned on this deposit. At an 8% annual return, the earnings are equivalent to a 1/12 of 1% annual premium. Further, when coupled with the already existing 0.3%, this 1% deposit immediately brought the Fund ratio to 1.3% of insured savings.

Each January, federally insured credit unions must forward to NCUA additional dollars to coincide with 1% of their growth during the previous year. This automatically adjusts the 1% portion of the Fund to keep up with credit union growth. The earnings from the Fund's investments are used to pay insurance losses, adjust the 0.3%, and pay other NCUSIF administrative expenses. Any surplus over 1.30% must be returned to credit unions under the law, and one "dividend" or rebate has been declared since 1985. As an added bonus, the original deposits and the annual adjustments go dollar-for-dollar to reducing the federal deficit. To date, the credit union deposit system has reduced the federal deficit by $1.7 billion (discussed in detail in Section V below).

If there are large losses to the NCUSIF, the statute gives NCUA the additional authority to assess in any year a 1/12 of 1% premium and to require credit unions to expense, or write down, a portion or all of the 1% deposit. Actually, the premium is automatically charged unless NCUA takes specific Board action to waive it, but NCUA has not needed to assess a premium in four years because of the soundness of our Fund. The NCUSIF is deliberately structured as a "pay-as-you-go" Fund in order to avoid the situation where problems are allowed to build up over the years. Every month NCUA staff makes a public report on the status of the Fund's payouts and investments, and annually an independent audit is conducted of the Fund, providing additional public overview on the operations of the Fund.

Accounting for the NCUSIF Deposit

Some have chosen to attack the NCUSIF deposit system as employing some type of "double accounting". As a factual matter, the NCUSIF accounts for the deposit as equity and credit unions account for the deposit as an asset, both quite correct accounting procedures.

The NCUSIF not only is subject to periodic audits by the U.S. General Accounting Office, but also it is the only one of the three federal deposit insurance funds to have an independent certified public accountant audit performed annually. The NCUSIF receives an unqualified opinion, with credit union deposits recognized as additions to the equity account of "Contributed Capital."

Credit unions also properly account for their NCUSIF deposits as assets, just as a deposit in another financial institution or an investment in a mutual fund or a mutual insurance company would be carried as an asset by any depositor/investor. An asset is something in which the institution anticipates "probable future economic benefits", according to the Statement of Financial Accounting Concepts No. 3. Credit unions expect continued federal insurance, the possible waiver or reduction of NCUSIF premiums, and a possible return on its deposits. Like other assets, the deposit is "at risk" in cases of financial catastrophes, requiring credit unions to expense part or all of the deposit and a replenishment of the deposit to the 1% level.

Recording of the NCUSIF deposit as an asset conforms to Generally Accepted Accounting Principles (GAAP). We are not aware of any credit union receiving a CPA audit that has received a qualified opinion because of the way the credit union accounts for the NCUSIF deposit.

III. HOW THE PROPOSAL WEAKENS THE NATIONAL CREDIT UNION SHARE INSURANCE FUND AND INCREASES CREDIT UNION INSURANCE COSTS

Put simply, Mr. Chairman, the Treasury "accounting change" raises credit union deposit insurance costs 250% of what they are paying today. Further, it returns our Fund to the old premium base. Ironically, the imposition of this credit union tariff and this de facto dismemberment of our unique Fund would contribute not one dollar to help in the S&L crisis, and would actually weaken our Fund.

The current credit union share insurance system has two significant features that provide strength and stability to the NCUSIF. First, credit union funding of the NCUSIF is tied directly to savings growth--it is virtually impossible for credit unions to outgrow the Fund. Second, the current system requires credit unions to pay for losses as they occur. Losses are not allowed to mount over several years to the point they swamp the fund. These two features have helped to produce what is, by far, the strongest of the three federal deposit insurance systems.

The Treasury's proposal would eliminate these two pillars of the credit union share insurance system. That would severely weaken the ability of the NCUSIF to handle large losses. Were it not for the underlying health of the

credit unions themselves--making large losses extremely unlikely--the proposal could cause a fiasco. As it is, the proposal introduces an unnecessary new source of risk and instability to federal deposit insurance.

Current System Adjusts for Growth

The Treasury proposal would replace the current system of a 1% deposit plus retained earnings with an eight-year write-down of the deposit and an annual premium of 1/12 of 1%. Because the current system requires credit unions to capitalize growth at 1%, and because 1/12 of 1% is 0.083%, the current system will provide a higher NCUSIF equity level than the Treasury proposal whenever annual savings growth exceeds 8.3%. Over the decade of the 80's, credit union savings have grown at an annual rate of 13.5%--in the 1970's, this growth rate was 15.5%.

Since these growth rates substantially exceed 8.3%, had the Treasury proposal been in effect for some time, the NCUSIF's ratio of fund balance to insured savings would be well below its current level of 1.25%. Actually there are two interpretations of the Treasury proposal that one might make. The one just described is contained in the proposed legislative language, and includes a 1/12 of 1% premium during the eight-year transition period during which the deposits are being written down. A second interpretation was provided by Treasury Secretary Brady in his February 22, 1989 testimony. He suggested that during the eight-year transition period, no premium would be collected. We suspect that this may be to portray the proposal in its best light, considering that the annual expense of the eight-year write down represents initially the equivalent of one and a half regular 1/12 of 1% premiums.

To illustrate the impact on the NCUSIF, we have modeled the current system and the two versions of the Treasury proposal for eight year periods beginning now. In all cases, we assumed an 8% yield on investments, and the average expense and insurance loss experience of the NCUSIF over the past few years. The results of the simulations are shown in Table 2.

Table 2
Ratios of Insurance Fund to Insured Savings

	Savings Growth=10%/yr.			Savings Growth=15%/yr.		
		Treasury Proposal			Treasury Proposal	
	Current System	With Premium	Without Premium	Current System	With Premium	Without Premium
Beginning	1.25%	1.25%	1.25%	1.25%	1.25%	1.25%
After 8 Yrs	1.28%	1.17%	0.60%	1.21%	0.83%	0.36%

If savings grew at 10% per year, the current system would yield a ratio of fund balance to insured savings of 1.28% after 8 years--1% in credit union deposits and 0.28% in retained earnings. Under the Treasury proposal including an annual premium, after eight years the fund balance would have dropped to 1.17%. If the Treasury proposal does not envisage a premium during the eight-year transition period, the fund balance would plummet to only 0.6%. If, on the other hand, savings grew at 15%--closer to recent experience--the results are even more striking. After eight years, the experience--the results are even more striking. After eight years, the current system would yield a coverage ratio of 1.21%, almost unchanged. Under the Treasury proposal with an annual premium, the coverage ratio would drop to only 0.83% after eight years. That is about two-thirds of the current ratio of 1.25%. If no premium were charged during the transition, the coverage ratio would go through the floor to only 0.36%--36 cents per $100 of insured savings.

Of course, the reason for the difference is that the current system requires credit unions to capitalize growth as it occurs. What is even more appealing is that the current system has some of the features of a risk-based premium system. The growth must also be capitalized where it occurs, i.e., at those credit unions experiencing the growth.

Under the Treasury proposal, a protracted period of rapid growth would probably lead to across-the-board premium increases to restore the ratio of the insurance fund to insured savings. Under the current system, this funding for growth happens automatically, and those credit unions with the highest growth make the greatest additional payments to the fund.

Credit Union Insurance Costs Would Escalate

Let me briefly outline how the Treasury plan would increase credit union insurance costs to 250% of present costs. This increase will be particularly burdensome to a number of small credit unions primarily serving low income members.

Presently, credit union costs consist totally of the earnings they lose on the 1% deposit. At 8% interest, this roughly equals a 1/12 of 1% premium. During the first year of this transition, credit unions will have the following costs:

a) Cost of writing down 1/8th of the 1% deposit. This is equal to 1 and 1/2 premiums. (No explanation was given as to why an eight-year write-down period was chosen.)

b) Loss of interest on the remaining 7/8ths of the 1% deposit (roughly equal to 1/15th of 1%).

c) Since NCUA will no longer get a deposit adjustment for credit union growth, the agency will have to charge a premium of 1/12 of 1% if the Fund is below 1.25%. Under the language of the current statute, NCUA would have to charge a whole premium, even if only a partial premium would be necessary. When this puts the Fund over 1.25%, there would be a rebate at year-end. We estimate about 1/2 of this premium would be rebated.

d) When these costs are added together and adjusted for average credit union growth, the cost to credit unions will be slightly over 2 and 1/2 premiums -- a lot more than banks are being asked to pay in order to shore up the FDIC which is now at an 0.83% equity level.

After the transition period, the Fund returns to the premium-only basis and the NCUA will charge annual premiums of 1/12th of 1% plus add-ons as necessary up to 50% above the previous year not to exceed 0.35 percent (4 premiums) to keep the Fund at 1.25%.

IV. HOW THE NCUSIF GUARANTEES THAT PROBLEMS WILL NOT GET OUT OF HAND

The NCUSIF: A Pay-As-You-Go System

The current NCUSIF system recognizes and deals with losses as they occur. Individual losses to an insurance fund usually occur in manageable proportions. Problems arise when several large losses occur at the same time (very unlikely except in a catastrophe) or when several large losses spread through time are not recognized as they occur and must all be dealt with at the same time. The current FSLIC problem illustrates the second case.

With the current credit union deposit system, annual funding to cover operating expenses and insurance losses comes from two sources. The first is the NCUA's earnings on the entire Fund's balance -- currently $2.0 billion. The second is NCUA's ability to levy a 1/12 of 1% annual premium. This premium has been waived since credit unions capitalized the fund in 1985.

Table 3 illustrates how the NCUSIF's annual operations are funded. (See the first column of Table 3.) With a total coverage ratio -- defined as the Fund's capital divided by insured savings -- of 1.25%, NCUA's annual interest income amounts to about 10% of insured savings. That provides available funds of 1.35% of insured savings. Recently, 0.02% of this has gone to operating expenses, another 0.05% to insurance losses, and the remaining 0.03% to build retained earnings, leaving an ending balance of 1.25%. A one year's premium of 1/12 of 1% would provide an additional 0.08% of insured savings. Thus, were insurance losses to rise to 260% of average--from 0.05% of insured savings per year to 0.13%--the NCUA could simply fail to waive that year's premium (0.08%) and the coverage ratio would be maintained. (See the second column of Table 3.) The highest loss NCUA has ever experienced was 0.11% of insured savings in 1982. This was an extremely stressful period for credit unions. The economy had weathered two recessions in three years. During much of the period, savings certificates were costing more than the then statutory 12% loan-rate ceiling at credit unions. Further, the financial services industry was in the throes of the shakeout that resulted from the deregulation that began in 1978. Thus, the simple ability not to waive the annual premium would provide for more than the worst year's losses on record.

Table 3
How NCUSIF Funds Annual Operations
All items as percent of insured savings

		Recent Typical Experience	Hypothetical Case: Insurance Losses at 260% of Average
	Beginning Balance	1.25%	1.25%
Plus:	Interest Income	0.10%	0.10%
	Premium (1/12 of 1%)	--	0.08%
Equals:	Total Available	1.35%	1.43%
Less:	Operating Expense	0.02%	0.02%
	Insurance Loss	0.05%	0.13%
	Retained Earnings	0.03%	0.03%
Equals:	Ending Coverage Ratio	1.25%	1.25%

How the NCUSIF Could Weather a Catastrophe

The ability of a deposit insurance system to withstand a catastrophe depends on its ability to handle large losses. Large losses to a deposit insurance fund can come from two sources: 1) the simultaneous failure of a very large number of representative-sized institutions, or 2) the failure of one or a few very large institutions.

The very strong financial condition of credit unions in general makes the simultaneous failure of a large number of credit unions extremely unlikely. Even then, the NCUSIF has sufficient capital to liquidate 890 credit unions of average size at a loss rate of 20% of insured savings.

The NCUSIF is also well positioned to handle a loss at a very large credit union. This is because credit union assets are not concentrated in a few large institutions. Instead, assets are distributed over a large number of credit unions.

Large Institution Failures - FDIC vs. NCUSIF

A comparison of the large institution risks faced by the NCUSIF and the FDIC is shown in Table 4. A serious failure at a large credit union would be only a glancing blow to the NCUSIF. That is not the case for the FDIC. The NCUSIF begins with a coverage ratio (fund balance to insured savings) of 1.25%; FDIC stands at 0.83%. Were the largest U.S. credit union to fail--at a whopping 20% loss rate--the NCUSIF coverage ratio would fall to 0.86%. That is very close to the current FDIC coverage ratio. Were the largest bank to fail at a 20% loss rate, the FDIC coverage ratio would go to negative 1.57%. Put differently, the NCUSIF has sufficient capital to pay for a loss amounting to 64% of savings at the largest credit union. For the FDIC, a 7% loss at the largest bank would absorb all of the fund's capital.

Table 4
Effect of Failure of Large Institutions
(Assumed Loss Rate - 20% of deposits)

	NCUSIF	FDIC
Beginning Coverage Ratio	1.25%	0.83%
Coverage Ratio Immediately Following Failure of:		
Largest Institution	0.86%	-1.57%
5th Largest Institution	1.14%	0.27%
10th Largest Institution	1.18%	0.60%

If the largest credit union were to fail at a 20% loss rate, the NCUSIF's coverage ratio would not long remain at its reduced 0.86% level. All remaining credit unions would be assessed an additional 0.14% of insured savings to bring their deposits back to 1%. That would be roughly equivalent to 1 3/4 annual premiums of 1/12 of 1%. From that point, it would take about three to four years to restore the entire Fund to its 1.25% level if losses returned to average levels. This would be accomplished simply by not waiving annual premiums.

If the fifth largest bank failed, the FDIC's coverage ratio would drop from 0.83% to 0.27%. The failure of the fifth largest credit union would lower the NCUSIF's coverage ratio from 1.25% to 1.14%. A full premium for one year and a half premium in the second year would restore the Fund to 1.24%. The failure of the tenth largest bank would lower the FDIC's coverage ratio to 0.60%. The failure of the tenth largest credit union would cut NCUSIF's coverage ratio to 1.18%. A single premium for one year would return the ratio to 1.25%.

A Hypothetical Worst Case

As described above, a 7% loss at the single largest bank would absorb all the capital of the FDIC. In contrast, it would require the simultaneous failure of the largest seven credit unions--at 20% loss rates--to exhaust the entire NCUSIF.

Should the entire NCUSIF be wiped out in this way, the remaining credit unions are required under the current law to make a deposit of up to one percent of their insured savings to replenish the Fund. In essence, credit unions would be required to immediately expense their one percent deposits. This write down would force another 41 credit unions--with total assets of $240 million--into insolvency. Were these credit unions to be immediately merged or liquidated at an average loss of 20% of assets, the fund would lose additional $48 million. That would leave the fund with a coverage ratio of 0.97%. In other words, there would be no domino effect caused by writing down deposits in an emergency.

V. WHY THE TREASURY'S CREDIT UNION PROPOSAL WOULD DO LESS TO REDUCE THE DEFICIT

Under the current NCUSIF funding system, credit unions contribute substantially to deficit reduction each year. All funds deposited with NCUSIF count against the deficit, as do all increases in the Fund's retained earnings. Since 1984, when the 1% deposit system was implemented, credit unions have contributed about $1.7 billion to deficit reduction.

The Treasury proposal would eliminate the annual increase in credit unions' deposits into the Fund in response to savings growth. This will sharply reduce credit unions' contributions to deficit reduction. The dollar amounts of deficit reduction under the current system and the Treasury proposal during the eight-year transition period are shown in Table 5.

Table 5
Size of NCUSIF Fund Balance
$ Billions

	Savings Growth=10%/yr.			Savings Growth=15%/yr.		
		Treasury Proposal			Treasury Proposal	
	Current System	With Premium	Without Premium	Current System	With Premium	Without Premium
Beginning	$2.0b	$2.0b	$2.0b	$2.0b	$2.0b	$2.0b
After 8 Years	$4.4b	$4.0b	$2.1b	$5.9b	$4.1b	$1.8b
Difference: (Contribution to Deficit Reduction)	$2.4b	$2.0b	$0.1b	$3.9b	$2.1b	-$0.2b

If credit union savings grow at an annual rate of 10% for eight years, under the current system the NCUSIF will grow from its current level of $2.0 billion to $4.4 billion. The increase of $2.4 billion represents credit unions' contribution to deficit reduction over the period. Under the Treasury proposal with premiums charged in addition to the deposit write-down, the Fund would grow to $4 billion, $400 million less than under the current system. The budget deficit would be $400 million greater over the period. If the Treasury plan did not include premiums, the Fund would stay virtually unchanged over the period, rising from $2.0 billion to $2.1 billion despite the doubling of credit union savings. The cost in terms of lost deficit reduction would be $2.3 billion compared to the current system.

If credit unions grow at an annual rate of 15% for the next eight years, they will contribute $3.9 billion to deficit reduction under the current system. Under the Treasury proposal with premiums, the contribution would drop to $2.1 billion--a loss of $1.8 billion. If the Treasury proposal were imposed without annual premiums, the Fund would actually decline by $200 million over the eight years. That would add $200 million to the deficit as opposed to the almost $4 billion reduction under the current system--a total swing of $4.1 billion.

VI. SERIES OF EVENTS SURROUNDING THE INCLUSION OF CREDIT UNIONS IN THE TREASURY BILL

Mr. Chairman, we have presented our best assessment of the facts and figures regarding the merits of the current credit union system. Proponents of the Treasury proposal, on the other hand, do not document their case at all. Instead it has been implied that our system is unsafe. I stated earlier that there is the dismay and disbelief spreading throughout the credit union movement over the dramatic increase in insurance costs. This distress is greatly magnified when members learn about a series of seemingly related events. Let me enumerate them.

Coincidence 1 - In his testimony before this committee, the Secretary of the Treasury explained the fund changes as being necessary to strengthen the Fund and because credit unions will "resist" any expensing of the 1% deposit. Basically, Mr. Chairman, we are saddled with unsubstantial claims that our Fund is unstable, and an accusation that we would lobby against the plan which we ourselves put together.

Coincidence 2 - In spite of repeated phone calls this January to White House planners, credit union officials were never consulted during the planning for the Treasury bill. During this time, wide press (photo) coverage showed banking officials in the planning sessions where the credit unions' fate was being determined. Only after the fact when the bill had been finalized and credit unions besieged the White House with calls, letters and telegrams was a meeting conducted. We were then basically informed that all insurance funds had to be the same and that our Fund was politically unstable.

Coincidence 3 - The Independent Bankers Association and the American Bankers Association have now taken official positions that credit unions should incur this dramatic increase in insurance costs by writing down the 1% deposit. To support their case, they are publicly stating that the credit union system is unstable.

Coincidence 4 - Credit unions are reading in newspapers (Enclosure 1) that banking officials are "concerned" about credit union "capital growth" and "regulatory structure." These officials make blatant and unsubstantiated comparisons to the S&L situation.

Coincidence 5 - Immediately after the release of the plan, CUNA began receiving press and Congressional inquiries about the safety and soundness of the credit union movement. For two years the country has been in the middle of this financial crisis, and during that time, we had virtually no inquiries about a credit union crisis. Suddenly, we are confronting a growing anxiety about the soundness of our insurance fund and this in spite of our extremely good health.

Coincidence 6 - When the plan was officially released, the headlines and lead stories in the banking trade press highlighted one fact: that credit unions had been nabbed by the bill (Enclosure 2). It seems revealing to us that these reports on a bill which completely overhauls the deposit insurance system and addresses one of the more serious problems facing our nation would hail a credit union "technical" change.

Coincidence 7 - Last year, the banking and S&L trade associations formally adopted as a top legislative goal the taxation of credit unions. In clear messages to their members and to the press, these associations announced that a major effort would be undertaken to use legislation as a means of attacking credit unions.

Coincidence 8 - Sec. 1001 of this Treasury bill provides that the following agencies shall conduct a study of the Federal deposit insurance system: Secretary of Treasury, Comptroller of the Currency, the Federal Reserve, the FDIC, and OMB. Conspicuously absent from a study which includes the credit union Share Insurance Fund is the National Credit Union Administration.

In conclusion, Mr. Chairman, let me summarize the perceptions towards these coincidences from credit union officials around the country.

Credit union officials are beginning to suspect that amidst the excitement, confusion and urgency of resolving the S&L crisis, the bankers, particularly the smaller independent ones, have successfully introduced a second agenda: take down the credit unions. This is being accomplished by: (1) deliberately sowing doubt and concern about credit union capital, regulation, insurance, growth, and overall safety and soundness; (2) attacking the credit union movement's reputation and integrity; and (3) seeking legislative tariffs such as taxation and increased insurance expenses in order to improve banks' competitive position. This is particularly ironic when you consider credit union total assets of $200 billion in comparison to our competitors $4.7 trillion.

We have no problem with decision-makers expressing interest in the credit union safety and soundness. We welcome it at any time. However, because of our adamant opposition to this provision, some are portraying credit unions as not wanting to do their share in this national crisis. First, we believe that developing and maintaining as healthy a sector of the financial community as we can should not be overlooked. Second, we fail to see where the banks are contributing anything themselves to resolving the S&L crisis. They are simply increasing their payments to their own deposit insurance fund to prevent the ratio from falling any further. We have already gone through the pain of doing this.

Finally, if this Congress determines that across-the-board sacrifices are required, we would certainly be willing to participate in developing such solutions. Often we are left out of the planning sessions and the across-the-board solutions fail to recognize the credit union differences and therefore cause severe, unintended, disruptions to the credit union system. Today's situation is a classic example.

VII. SUGGESTED CHANGES IN THE ADMINISTRATION'S PROPOSED "FINANCIAL INSTITUTIONS REFORM, RECOVERY, AND ENFORCEMENT ACT OF 1989"

Mr. Chairman, the following constitute our recommendations for changes in the proposed legislation.

First and foremost, credit unions want the law governing the 1% deposit into the National Credit Union Share Insurance Fund left intact. The proposed change would weaken, not strengthen, the Fund. If Congress is seeking consistency, use the NCUSIF equity system as a model, and require

all federal deposit insurance funds to make monthly reports on their conditions to the public and have annual independent audits, as does the NCUSIF.

We believe Congress needs to thoroughly examine the proposed enforcement powers in Title IX of the bill. Rest assured, credit unions want criminals punished and we want them out from behind teller cages and presidents' desks. Million dollar penalties might be a little bit of overkill where half the nation's credit unions have less than $2 million in assets, and where the average credit union has $12 million in assets and annual net income of $100,000, but if uniformity will help prosecutors, we have no objections.

However, there are at least two enforcement provisions that need much closer Congressional scrutiny. The first is the proposal to amend NCUA's cease and desist authority to allow the agency to require of any credit union director "without limitation, reimbursement, restitution, indemnification, rescission, the disposal of loans or assets, ...guarantees against loss, or other action the [NCUA] Board deems appropriate." A basic tenet of credit unions is the volunteer board of directors. (Under the provisions of the Federal Credit Union Act, only one board member can be paid, and even then, most credit unions pay none of their board members.) Corporate law does not require (or expect) perfect business decisions, and reasonable men (including examiners) can differ on business decisions. The broad grant of authority in this draft language should be restricted to those cases where an individual has been unjustly enriched in connection with a violation or practice, or where the individual's activity involved a reckless disregard for the law or regulation.

A second enforcement provision requiring closer scrutiny is the proposed civil and criminal forfeiture provisions. Proposed Section 983 states that any real or personal property which is traceable to the proceeds of a crime against a federally insured financial institution will be subject to forfeiture to the United States government. We understand the language of the bill to say that if the credit union is in receivership, the general Treasury gets most of the money; NCUA would only get that portion of the value of the money attributable to the "contribution of resources to, or expenses involved in, the seizures...." In these cases, the Share Insurance Fund has undoubtedly incurred losses through the payouts it will have made to insured shareholders. The NCUSIF, rather than the general fund, should be the beneficiary of the value of any property recovered, up to the losses it has incurred on the credit union in receivership.

We request that Congress protect the Central Liquidity Facility which is administered by the National Credit Union Administration. The CLF was established for credit unions in 1978 at a time when credit unions were borrowing money in order to meet members' loan demands. Credit unions have rarely been subject to liquidity pressures since the early 1980's, but the CLF remains an important standby arrangement with authority to borrow up to $600 million a year through the Federal Financing Bank. The Administration's FY1990 budget proposes to cut the CLF off from the FFB financing. We object to any Administration efforts to undermine the credit union liquidity "safety net," especially at the same time the Federal Reserve Board and the Federal Home Loan Bank Board are busy knitting a liquidity net for the savings and loan industry.

Finally, there are two items in the Treasury bill which should be amended. NCUA should be released from the salary constraints it currently functions under in paying credit union examiners, similar to the authority proposed for the other federal financial regulatory agencies. The payroll costs of examiners are paid for by federally insured credit unions, and NCUA must be able to compete to find and retain competent staff. NCUA had to fight the Office of Management and Budget in order to do so, but the agency has been able to increase its examiners' force by 50% over the last three years. Credit unions have not objected to the significantly increased NCUA budget, a budget which is funded totally by credit unions. NCUA recognized years ago that deregulation requires more, not less, supervision.

CUNA feels that the Chairman of the National Credit Union Administration should "be at the table" in any study of the deposit insurance system mandated by Congress. Our experience with the drafting of this piece of legislation shows its better to be there to defend a different system rather than expect people to take the time to understand the merits of the NCUSIF structure.

Thank you, Mr. Chairman. I would be pleased to answer your questions.

The CHAIRMAN. Thank you very much, Mr. Williams.

Let me at this point raise a question with both of you.

The credit union movement and system has a lot of friends on this committee, people who feel that credit unions do a very important job in our financial service system. I certainly have that view.

But I want to pose some tough questions to you that in a sense are the questions that are phrased by other competitors and others who have a view that is much tougher in terms of its view of the credit union system.

For example, one of the questions that's been raised is that what we've been discussing is whether or not we sheer off, if you will, State powers and authorities that are added on to thrift charters, and yet, come back in on Federal deposit insurance.

If we do that or if there's a certain strong argument that can be made for doing that, why shouldn't that also as wisely apply to the credit unions? If we're going to have a Federal deposit insurance system in effect for the credit union system, why shouldn't we have a uniform 50-State charter for credit unions? If individual States want to go further afield with powers that have a higher risk profile, why shouldn't those be disconnected so that they don't hang out there as a potential threat to your own insurance system in the future?

FIFTY-STATE CHARTER FOR CREDIT UNIONS

Mr. WILLIAMS. Mr. Chairman, if I may, I would like to address that. Being a State-chartered credit union from the State of Alabama, in 1975 when we applied for insurance under NCUA there were certain requirements that we had to meet. Under one of those requirements, we signed an agreement that if our State statute allowed us to do anything that was prohibited under the Federal statute, then we could not do it. We are still living under that and our State statute, if there are limitations placed at the State level we have to comply with that. Yet if there are things that we can do that are prohibited under Federal, then we cannot do it. So we had to sign an agreement that we would do that to keep our insurance in effect.

The CHAIRMAN. Mr. Robinson.

Mr. ROBINSON. Mr. Chairman, though we are primarily interested in the federally chartered credit unions, we watch very carefully what goes on in the realm of the State chartered credit unions as they participate in the share insurance fund.

There have been days in the past when we were more concerned than we are today. We think the National Credit Union Administration has put together an excellent program in working with the State supervisors and, as Mr. Williams has indicated, they have to meet Federal standards to get Federal insurance.

We think the system is working very well and the people on both sides, both the State side and the Federal side, are very attentive and very accommodating to each other. The State chartered credit union representatives have come to our association to meet with our officers to explain what their concerns are and we certainly can raise our concerns with them. We think the system is not hurtful and it is working.

The CHAIRMAN. Well, for a long time we thought that was true in the savings and loan system as well, but we've had what I can genuinely call a catastrophic systems failure. There are a number of elements that happened over a period of time, but despite a lot of good intentions, all of a sudden we find the system as a whole in very serious difficulty and with a massive amount of money gone.

Now the taxpayers are being asked to step in and replace the losses. One assumes in any other part of the financial system, should there be a catastrophic systems failure, the result would be the same—that the Federal taxpayer would be asked to be the person to step up as a last resort and to make up the losses.

So, I think the one thing the savings and loan problem does is that it forces on us a requirement not only to reengineer that system so it hopefully will not be susceptible to the system failure in the future, but to also see if there are any elements in that failure that may well be latent and that despite everybody's best intentions, could malfunction in the future and open us up to the same scale of liability. I think that one is one that requires a very careful look.

I had asked you a question, and you have given us your response. But I think that's something we have to take a much closer look at.

Let me ask a different question. The Independent Bankers Association testified that they thought there was a considerable danger in permitting a single agency to both charter and insure financial institutions. Of course, that is the centerpiece issue in the savings and loan area, and one of the things the administration bill changes. I think this committee overwhelmingly favors splitting those apart.

Yet today, in the credit union system you have those two functions combined.

Why again, just in terms of looking forward should this be the case? Maybe the time to build in additional safeguards into the system is when we don't have a major problem so that we lessen the chance that we might have one in the future.

But if that makes good sense in the savings and loan system, why wouldn't it make good sense in the credit union system?

Mr. WILLIAMS. Mr. Chairman, if I may address part of that question, in that we feel that within the credit union movement that the insurance fund drives the regulations, not the other way around. In other words, we are concerned with the safety and soundness of the credit unions and the protection of the insurance fund because we do have our 1 percent deposit up there.

We are concerned that we keep the examiners, make sure that examinations are done annually. We have been converted to a CAMEL rating system similar to the FDIC that uses this. We have added over 50 percent growth in examiners within the last year in order to make sure that things like this do not occur and impact the insurance fund.

Mr. ROBINSON. Mr. Chairman, we have looked at two models, the FDIC model, which you might say is the separated model, and the FSLIC, which is the combined model, and we found that neither one of those is perfect. The FDIC Chairman just reported the other day they lost something on the order of $4.7 billion, and the FSLIC hasn't done very well either, though they are the other model.

We are suspecting that maybe it isn't the structure per se that guarantees success or failure, but the people who are making that structure work. Good managers can make even a poor structure work.

What we like about the NCUA arrangement is that the insurance fund looks over the shoulder of the chartering side of the house, and the insurance fund is constantly reminding them if you make these very liberal, wild-flying authorities, we are going to pay for that on the insurance side of the house.

So, in essence, the insurance side of the house, because they are familiar with what the chartering side of the house is doing, acts as a brake on the other side.

We also note that if you are going to separate the two you are going to be facing the problem of creating an additional bureaucracy. Many of the people in the National Credit Union Administration serve both the insurance function and the chartering function. If you separate those two out, you are going to either take some people away from one, put them all in the other, or create a whole new bureaucracy.

We think that because the people who insure our credit unions and the people who charter credit unions are both paying attention to each other, we think that system is working and it is doing very well for us.

The CHAIRMAN. Let me yield to Senator Pressler at this point.

Senator PRESSLER. Thank you very much.

I would ask this question. This question does not reflect my position, but it is something I think we need to get into the record.

I thank you very much for your testimony, and I want to say that I am proud that in the room is Don Couch, the head of our South Dakota credit unions. And this is not his question either, but I just have to mention that at this point.

I have read with special interest your statements and heard them with respect to the proposal to require credit unions to expense their deposits over an 8-year transition period.

In that connection, am I correct in understanding that the deposits are treated as capital of the credit union?

Actually, this is a three-part question. I will read it all and we can go back over it if any of you want to.

Does that increase the amount of lending that the credit union can undertake, and how does this affect the average credit union?

I think this three-part question, it is important to have the answer to this in the record. So anybody can tackle that.

Mr. WILLIAMS. OK, Senator. I got down two of the points. Maybe I would have asked you the third one.

But the first one, the capital, the only way it increases the capital is that we do record it as an asset on our books, which if we recorded it as expense it would have decreased the capital for that year, the portion that went in there. That is the only way. It is not included in computing the capital ratio on each individual credit union.

The second question, or the third question on that, since the actual dollars are sent to the fund, we do not have those dollars to generate loans on it.

And I forgot the third point.

Mr. ROBINSON. How does it affect credit unions?

Senator PRESSLER. Well, in understanding that the deposits are treated as capital of the credit union, am I correct in that understanding?

Mr. WILLIAMS. No.

Senator PRESSLER. OK. Then does that increase the amount of lending that the credit union can undertake?

Mr. WILLIAMS. No, because we do not have the dollars. We actually sent the dollars to the fund.

Senator PRESSLER. All right. Then how does this affect the average credit union?

EFFECT ON THE AVERAGE CREDIT UNION

Mr. WILLIAMS. The average credit union, the 1 percent deposit that they put up affects the credit union like in any normal operations. They simply have to have that cash flow in order to insure that. The deposit is made, and it is a public image that they are insured, and so forth.

Senator PRESSLER. Good. Well, I am a member of two credit unions myself. I haven't got any loans recently, but I very much appreciate the services they render in my State of South Dakota and elsewhere, and I look forward to working with you on this problem. Thank you.

The CHAIRMAN. Thank you, Senator Pressler.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

I would like to direct a couple of these questions to Mr. Williams, since he comes from my State of Alabama, but he is also experienced and knowledgeable in this area.

What are the total assets for credit unions in my State of Alabama, roughly?

ALABAMA CREDIT UNIONS

Mr. WILLIAMS. Total assets is right at $2 billion.

Senator SHELBY. $2 billion.

Mr. WILLIAMS. In the State of Alabama.

Senator SHELBY. Out of a State of 4 million people?

Mr. WILLIAMS. Right.

Senator SHELBY. OK. What is the largest credit union in Alabama?

Mr. WILLIAMS. The largest credit union is Redstone Federal Credit Union in Huntsville, AL.

Senator SHELBY. About what kind of assets would you——

Mr. WILLIAMS. They are right at $500 million, $600 million.

Senator SHELBY. How large is your credit union in Listerhill?

Mr. WILLIAMS. We serve 29,000 members, and we are $86 million in assets.

Senator SHELBY. Have you had any credit unions in Alabama to fail in the last several years?

Mr. WILLIAMS. As insolvent credit unions, no. We have had several merged credit unions, and so forth, but the majority of those were due to plant closings.

Senator SHELBY. Relocation of workers?

Mr. WILLIAMS. Right.

Senator SHELBY. Not financial closings?

Mr. WILLIAMS. No, sir.

Senator SHELBY. Well, I am a member, as Senator Pressler says, most of us are members of a credit union. When I came from the House to the Senate, they showed us we had a credit union and they do a good job and it seems to work. We all do business with banks, savings and loans, and credit unions, and I have been a big supporter of the credit unions, as you well know.

Something that bothers me is borrowing short, as we say, from the depositors and lending long at fixed rates. It looks to me like that would be a caution flag thrown up on that because of the past history of the thrift industry. That got the thrifts in trouble.

And how much of that is going on nationwide and then my State?

Mr. WILLIAMS. Mr. Chairman, the nationwide real estate lending in credit unions is only 18 percent of their assets.

Senator SHELBY. 18 percent?

Mr. WILLIAMS. 18 percent.

By lending long you are referring to——

Senator SHELBY. Fixed rates.

Mr. WILLIAMS [continuing]. Fixed rates. In our credit union right now the maximum length of a fixed rate loan is set by the board of directors and ours is 15 years. That is by statute. There's no 25- or 30-year loans. If the credit union member wishes to go 25- or 30-year loans, then there is a way that we can do the lending, and it goes into the secondary market.

Senator SHELBY. Is that where you sell it to Fannie Mae and others?

Mr. WILLIAMS. Right.

Senator SHELBY. And you just service it?

Mr. WILLIAMS. Right.

Senator SHELBY. How much of that is being utilized in the credit unions around the Nation, dealing with the secondary?

Mr. WILLIAMS. I think in the last year there was only around 2,000, 4,000 loans that were actually originated and sold into the secondary market.

One thing that I might mention on this—and I will use an example of Listerhill Employees Credit Union—we are very aware about bringing in deposits short term and going long.

We have a maximum 15-year loan policy on fixed rate loans, but we also cap the maximum that we will put in there. We will only put 25 percent of our portfolio of loans into real estate loans.

So we safeguard it with 15 years and then a maximum that we will put in there.

Senator SHELBY. What are your overall losses nationwide out of your credit union fund as a percentage of the fund?

Mr. WILLIAMS. I think Ken mentioned there a while ago that this last year it was a $47 million loss—or $60 million?

Mr. ROBINSON. They have booked a $60 million loss, but that doesn't mean they have paid out the money yet.

Senator SHELBY. $60 million losses out of a fund of how many?

Mr. ROBINSON. $2 billion.

Senator SHELBY. $2 billion. That is pretty good. That is better than pretty good. That is good.

Mr. WILLIAMS. One thing that I might mention that Ken just mentioned there, too, also, when he said "booked." If the insurance fund realizes that there is a potential loss, they go ahead and book that as a potential on their books instead of waiting till the actual loss occurs.

Senator SHELBY. Let me go right back one more time to the borrowing short and lending long on fixed rates.

Do you believe that is a danger signal out there that you should heed at times based on what has happened to the thrifts in the past in doing that, notwithstanding your current practices?

BORROWING SHORT AND LENDING LONG

Mr. WILLIAMS. You know, I would have to go back and say that each credit union's board of directors has to make those decisions. I understand that.

Senator SHELBY. Sure.

Mr. WILLIAMS. But any time, and up until the IRA provision was there, the credit union always had short term money, always, and we stayed strictly in the consumer business with 4 to 5-year loans on consumer loans. The real estate lending at that time was very negligible. But now that the credit unions can do IRA accounts we do have some long term money out there, and so forth.

Senator SHELBY. Longer than you had anyway?

Mr. WILLIAMS. Longer than we had. Of course, now we are looking at maybe 6 or 7 years that we know we have that money, and there must be some place to make that money work for the membership.

Now, is real estate the place it should be, or should it be in investments?

That is decisions each individual credit union has to make, but I think as a movement we try to point out the pitfalls and literature and everything else that we can of bringing in short term money or high rate money and trying to long fixed rate.

Home equity lending in the credit union movement is almost 100 percent variable rates.

So we seem to be getting the message across that that is the way that it should be.

Senator SHELBY. Go ahead. Did you want to comment, sir?

Mr. SWOBODA. Yes, sir, Senator. Ralph Swoboda, President of CUNA. Just a comment.

Al was talking about lending at Alabama State-chartered credit unions, which are limited in making fixed rate mortgage loans. Congress has permitted Federal credit unions to go out to 30 years in mortgage lending, but we calculate that less than 10 percent of credit union assets nationally are in fixed rate real estate loans.

And getting back to Senator Riegle's point on this, this is one example where actually Federal law is more liberal than State law. In general, the States have been more restrictive as to the powers of credit unions than the Federal Credit Union Act, and that is reflected in the chartering numbers, more Federal charters granted than State charters.

But the experience of credit unions has been traditionally to avoid funding their assets on a short basis, and that is what has stood us very well through high interest rates and inflation. The bulk of credit union lending is short term, 3 to 4-year auto lending, installment lending, and that kind of thing, and that avoids the kind of problems that I know is of concern to the committee.

Senator SHELBY. Well, you see the concerns. We don't want anything to happen to you—you have been running your institutions well—that happened to the thrift industry, and history will repeat itself sometimes, and this has been a sticking point and lot of our concerns, short versus long and fixed rates, and you are already addressing it, and maybe with a secondary market you can move into that because you certainly don't want to be cut out from making real estate loans, but you certainly at the same time should be very prudent with your money, shouldn't you?

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Shelby.

Let me ask a couple of other questions. In terms of other activities, what powers are you presently exercising in investing in stocks and bonds, and what can be done in subsidiaries in terms of the range of activities?

Mr. WILLIAMS. Mr. Chairman, I will address that from the State level and ask Ken to address it from the Federal credit union.

In the State of Alabama our investments are restricted to government securities, investments into other financial institutions that are insured, and we cannot invest in any equities whatsoever.

Mr. ROBINSON. The federally chartered credit unions are also limited. Our credit unions may only invest in government-insured instruments.

Now, you asked about subordinate subsidiaries, and so on?

The CHAIRMAN. That is exactly right.

SUBORDINATE SUBSIDIARIES

Mr. ROBINSON. There is a provision for credit unions to have the credit union service organizations. They are limited to the amounts of money they may invest in those organizations. They can only put up a very small amount of capital, 1 percent.

None of them can invest in stocks, either the parent credit union or the CUSO.

The CHAIRMAN. There is no subsidiary of any credit union anywhere in the country that can do that?

Mr. ROBINSON. Not that I am aware of, and I have never seen anything that would indicate—that the Government would insure any investment in any stocks.

The CHAIRMAN. Let me ask you one other question here today—and another member of the committee has asked me to raise this in his absence—which has to do with the question of the philosophy going back to the common bond issue.

I believe most of us think of credit unions as being an affiliation of members that are in the same geographic area and have a purpose of one kind or another that draws them together in an affiliation. We now have a very significant anomaly coming into being with the AARP, a national credit union in effect, where you have members across the 50 States. You obviously break the nexus of a geographic tie and you appear to break the nexus of the kind of an affiliation of which that we have traditionally thought. So, it becomes something that is in a sense a difference in kind, although that is arguable. Obviously it is something that has taken place and appears to be working well.

But what does this mean for the future? Are we likely to see other national credit unions, if you will, follow this model? Are we seeing the system being altered by that kind of basic new step on that scale?

Mr. WILLIAMS. Mr. Chairman, if I may, I would like to address that.

In the late 1970's there was almost 23,000 credit unions. Today, as I stated, there is 15,800. A lot of this was forced on us in the late 1970's and early 1980's because of plant closings.

Instead of liquidating those credit unions and, if there was any loss, charging it to the fund, then the regulators, both State and Federal, allowed those credit unions to merge into other credit unions within the community, which actually the loss would not be charged to the fund, and also it would continue to offer services to those credit unions.

You know, the field of membership question is one, I think, that has occurred over time. The field of membership and the common bond, as we grew up in the credit union movement was basically one employer. I think that was done because that was the easiest way to organize credit unions.

But our history tells us that the original credit union movement was based on serving the community, not an individual employer, if we go back in U.S. history, and so forth like that, and I think one thing—and I would like to use a quote here from—a quote that was made by Judge Mirand, and I don't think we want to be included in what he said, and he said that "Credit unions should be in the basement of the plants that are closed."

That is why some of us have had to expand our field of membership. In 1979 we had 6,500 employees at Reynolds. Today we have 2,500. We had to do something in order to even serve the membership that we already had.

The CHAIRMAN. I want to put a comma at the end of your statement.

Mr. WILLIAMS. OK.

The CHAIRMAN. Then I would like sort of the rest of the response, and that is how do we start to view conceptually and in practice the development of a 50-State credit union of very substantial size? Isn't that a difference in kind and, if so, what does it mean one way or the other, and what are the policy implications for the future?

A NATIONAL CREDIT UNION

Mr. WILLIAMS. I didn't reference AARP. That was the one that you were talking about on it.

The CHAIRMAN. Yes.

Mr. WILLIAMS. It is my understanding—and I can be corrected, and we would provide you information later for the record on this—is that there is a complete review at the NCUA on the chartering and field of membership question and whether or not the AARP should be allowed or should the associations be served on a local level instead of on a national level.

That is a study that is being done right now to be presented to the board at NCUA.

The CHAIRMAN. So I take it, then, there are differences of views and that is posing some very fundamental policy questions and dilemmas within your own organization?

Mr. WILLIAMS. Within our own movement, yes, sir.

The CHAIRMAN. So, you are looking at that question. You haven't made any final judgments on it, but I assume in due course you will do so and you will let us know yourselves how you view this rather new development?

Mr. WILLIAMS. Yes.

The CHAIRMAN. Yes?

Mr. SWOBODA. Just an additional comment, Senator, with regard to AARP.

I think it is very much a special case of a credit union that was chartered in particular response to the needs of elderly Americans who don't have, in many cases documented, the same access to the credit cards, and so on, as ordinary citizens do.

I think it is worth noting that most people like to use a financial institution that is convenient, where they can walk into the lobby and talk to the teller, and notwithstanding all the publicity about the AARP credit union, their assets are still less than $25 million at the latest number that I heard.

Most people don't want to get credit union services through the mail.

But I think the basic point is one that you made yourself, that it is an unusual case, designed to meet a particular need of a part of the population.

NCUA has since adopted a new chartering manual and, as I read the policies in that manual, a charter like AARP would not be granted today. As Mr. Williams has indicated, this whole area is one of controversy within the credit union movement.

The CHAIRMAN. Mr. Robinson, would you want to add anything to that?

Mr. ROBINSON. Well, Mr. Chairman, the lessening or the broadening of the fields of membership really started in 1982 because of economic disruptions in the country. I think that pendulum has swung about as far as it is going to swing. We are now seeing it beginning to swing back in the other direction again.

I agree with Ralph Swoboda that AARP Federal Credit Union is a specialized operation, virtually always by mail, and it is mostly for people who can't get downtown to the bank but who can get down to their mailbox.

The AARP itself is more of a bogey man than it is a real threat.

The CHAIRMAN. You know, it is interesting. The savings and loan problem brings into focus a host of other issues and tensions that are out there in our dynamic financial services system because the commercial bankers, obviously they have their competitive feelings about the credit union movement, and vice versa, and the savings and loans can go into that mix as well.

There is a certain tension for customers, tension as to who provides the services. Everybody wants a level playing field, but everybody sees the level playing field from a different vantage point.

The problem is not trying to agree that we ought to have a level playing field, but is it possible to level it out in a way that satisfies the competing interest groups.

Those questions are not going to be resolved in this legislation, but this legislation starts to draw those questions forward in a broader debate as to where is our financial services system is going for the future. It is very much a centerpiece argument in terms of the savings and loan system of the future. In writing this legislation and restructuring the industry, restructuring the charter, restructuring the insurance system, restructuring the regulatory arrangements, we are setting in motion a revised savings and loan industry, that in its own ways will have a bearing on the opportunities and activities and adjustments that will go on with credit unions, commercial banks, and others.

These broader policy questions, I think, are ones that are going to assert themselves more and more. You mentioned the consolidations that have gone on in the credit union movement with the recession in the early 1980's. It really hammered a lot of our industrial credit unions.

We certainly went through that in Michigan, as much as probably any State, and I am happy to say that our unemployment rate, as announced 2 days ago in Michigan, was 6.1 percent, which is the lowest level in 17 years. Fortunately, we are making progress as we are in large measure across the country.

But as we go down the track, we have a new committee with each Congress, and I am new to this chairmanship. We have new members on both sides who have not previously served on the Banking Committee, and so one of the areas where we will want to have a close and continuing relationship and discussion is the question of how we view the array of financial service players, and what constitutes the balance of the rules and regulation that really meet the public interest. I would like to think that we start and end there. Then, we go out through all the private sector arrangements, but we come back to a very careful examination of whether in fact we are meeting the public needs and requirements with a sensible, sound, safe, intelligent system.

We will be talking further with you about it, and this opportunity today gives us the chance across the two tables to get started with the next chapter in that relationship.

So I want to thank you.

Did you want to make a comment, Mr. Williams, before we close?

Mr. WILLIAMS. Mr. Chairman, I would just address your last comment there.

We stand ready to help and to assist in any way that we can with any expertise or anything that we have within the credit union movement and defining the services, and so forth.

We are available, and all it is is a telephone call, and we would serve on any committees or any study groups or anything else that may be appointed to look at this question.

The CHAIRMAN. Very good.

Mr. SWOBODA. Senator?

The CHAIRMAN. Yes.

Mr. SWOBODA. If I could note, with just maybe perhaps a degree of levity, there has been a lot of discussion about the use of the logo.

We are very proud of our fund, and we would be willing to let any bank or S&L that wants to put up 1 percent use our logo. [Laughter.]

The CHAIRMAN. What a gracious act.

The committee stands in recess.

[Whereupon, at 11:55 a.m., the committee was adjourned, subject to the call of the Chair.]

[Response to written questions and additional material supplied for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
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March 28, 1989

Edward Malin
Editor
United States Senate Committee
on Banking, Housing, and Urban Affairs
Washington, DC 20510-6075

Dear Mr. Malin:

Enclosed is the responses of the Greenlining Coalition to the questions raised by Chairman Riegle at the March 15, 1989 Banking Committee panel on S&Ls.

Q.1. Do you support increasing the qualified thrift lender test to 70%? If so, please be specific explaining why you believe this is necessary?

A.1. In part, we support a 70% test. We, however, believe that Congress should go further and require S&Ls to invest exclusively in housing, with particular emphasis on low-income housing. We should require that at least 80% relate to residential mortgages. The only exception would be for low-cost economic development that assists in the revitalization of inner cities. We believe that there is no purpose in preserving S&Ls unless they perform an important and unique function among financial institutions.

Q.2. Do you believe the qualified thrift lender test should be clarified and narrowed to include only activity which is directly related to housing finance? If so, please be specific explaining your position?

A.2. Please see answer to Question one.

Q.3. What additional specific recommendations would you make for breaking up the historically close relationship between the thrift industry and its regulator?

A.3. The inherent conflicts of interest regarding the regulated and the regulators is more than a matter of structure and/or perception. It is essential that S&Ls have a clear mission and that this mission be carried out at the highest levels. It might be noted that the Federal Reserve Board and the Federal Deposit Insurance Corporation, which historically have been "independent" of the institutions they regulate, have also failed to address redlining. Thus, structural independence is not the answer by itself.

We also respectfully would call to the Committee's attention the March 9, 1989 statement of Congressman Fortnoy Stark before the House Ways and Means Committee. He stated that all savings and loans engage in redlining and the regulatory authorities are either unwilling or unable to eliminate redlining. We believe this is additional evidence of the all too-cozy relationship, combined with the lack of a clear mandate, and sense of purpose that permeates the savings and loan industry.

Sincerely,

Robert Gnaizda

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM KENNETH L. ROBINSON

Q.1. The Administration's bill would require credit unions to write down over eight years the one percent of their insured deposits presently held in their insurance fund. The American Banker's Association has testified in favor of this proposal because, in its view, there is no reason why this one percent of money should be counted as capital for both the industry and its insurance fund. Mr. Rideout, the ABA witness, claims permitting this double counting creates a safety and soundness issue of significant dimensions because in a crisis the credit unions will lose one percent of their capital at the same time their insurance fund is going broke. How would you respond to the ABA's concern?

Answer 1: The current accounting treatment of credit union capital raises no safety and soundness problems for either federally-insured credit unions or for the National Credit Union Share Insurance Fund. First, credit unions' aggregate capital to asset ratio is now and has been consistently higher than those experienced by banks over this decade. For example, federally-insured credit unions' capital asset ratio has averaged 6.95 percent since 1984 -- or 12.5 percent above the 6.18 percent level registered by banks during this period. In light of the fact that credit union growth during this period has been quite rapid, plus the fact that credit unions' loan portfolios are considerably less risky and do not contain items of questionable value such as LDC debt, credit union capital is quite strong and, by comparison, excessively sufficient to guarantee safety and soundness.

Second, in order for credit unions to expense a single dollar of its deposit at NCUSIF, total NCUSIF losses would have to exceed $667 million -- an amount equal to 8.6 times NCUSIF's worst annual loss ever, or 16.6 times NCUSIF's five-year average loss. If losses of a similar proportion were to be experienced concurrently by FDIC, that fund would be in the red by over $10 billion dollars at the same time NCUSIF's reserves to insured ratio would be at 1.0 percent. Thus, the NCUSIF is capable of withstanding losses which would be catastrophic to FDIC without credit unions losing a dime in the fund. A loss necessary for credit unions to lose their entire NCUSIF deposit would result, by contrast, in a $250 billion loss to FDIC in one year.

In the unlikely event that losses exceeded $667 million, credit unions would be required to expense whatever funds were necessary to return the NCUSIF to 1.0 percent. From a policymakers perspective, this system is superior for two reasons. First, it creates market incentives to minimize insurance fund losses by giving insured institutions a vested interest in the safety and soundness of the fund; had such a system been in effect among federally insured S&L's, we are convinced that the nation would not be burdened today with the FSLIC crisis. Second, the credit union system guarantees that the insurance fund will never drop below 1.0 percent; had such a system been in effect among federally-insured banks, FDIC would have experienced an inflow of roughly $3.0 billion in 1988.

Q.2. The ABA stated in its testimony that since 1982 the average annual growth rate of credit union assets exceeded 17 percent and this fast growth has lead to increasing credit quality problems. It asserted that these credit quality problems are evident in the fact that loan losses at credit unions rose 64 percent from 1984 to 1987. Is it true that credit unions are experiencing an increasing percentage of loan losses and if so is that not an argument in favor of the Administration's proposal for raising their capital?

Answer 2: It is true that credit union assets have been growing rapidly; from 1982 to 1988, the average annual growth rate of federally-insured credit union assets has been 16.9 percent.

It would have been a remarkable feat indeed if loan losses had not increased at all during this period of rapid growth. However, it is more useful to discuss loan losses in proportion to assets. While the level of loan losses have been increasing for federal credit unions, it is important to note that -- as a percentage of assets -- these losses remain only 0.386 percent of credit union assets. By comparison, losses at FDIC-insured institutions surpass those at credit unions by over 50 percent, or 0.585 of total assets. We appreciate the ABA's concern in this area, but respectfully submit it is misdirected.

Thus, the premise upon which Question 2 is based is quite misleading, as is its conclusion. Even if credit union losses were increasing as a percentage of assets, this would not be an argument in favor of the Administration's proposal as embodied in Title XI of S.413. This is because the provision in question does nothing to raise credit union capital levels which, as indicated in the answer to Question 1, exceed bank capital levels on average.

Q.3. The ABA testified that a credit union task force organized in March 1988, which in included representatives of the credit union associations testifying today, concluded that the credit union industry needs higher capital standards. Is this true and if so why is not the Administration's proposal a fair way for the credit unions to achieve those higher capital standards?

Answer 3: It is not true the credit union task force in question -- which is known as the Reserve Study Commission (RSC) -- concluded that the nation's credit unions need higher capital standards. The purpose of the RSC was to study methods by which credit unions could better reflect the nature of risk assets in determining their reserve needs.

As indicated earlier, there is nothing wrong with the current capital levels. In fact, many credit unions are at or above the current reserve levels required by statute, but nonetheless continue to contribute to reserves above these levels. However, the current reserving procedure was instituted in the early 1970's, and the assets of credit unions have changed considerably in terms of both size and composition since then. To reflect the changing structure of credit union balance sheets, the RSC -- whose report was released just earlier this year and is now being comprehensively studied by the credit union community -- examined several ways to change reserving procedures to improve the degree to which reserves reflect risk. Indeed, it is our belief that such adjustments to reserve calculations would indicate that the vast majority of credit unions have adequate or even excessive capital levels relative to the risk nature of their assets.

Thus, the RSC is just another example of the high degree of self-evaluation inherent in the credit union community. As in 1984 -- when Congress considered and enacted NCUSIF recapitalization legislation, which was initiated by the credit union community itself after conducting a comprehensive examination of the safety and soundness of the credit union system -- the credit union community has taken positive action not to deny or cover-up known and existing problems but, rather, to address a potential long-term area of concern in a timely, comprehensive, and proactive fashion.

Q.4. The Independent Bankers Association testified that the FSLIC crisis demonstrates that there is considerable danger in permitting one agency to both charter and insure financial institutions. The National Credit Union Administration does both. Do you believe Congress should separate NCUA's chartering and promotion functions from its insurance responsibilities? If not how do you distinguish your industry from the thrift industry in this regard?

Answer 4: NAFCU believes it is neither wise nor necessary to separate NCUA's chartering and insurance functions for the following reasons.

First, there is nothing in recent history to convince us that the separation of these two functions is an essential component to effective regulation of depository institutions. The enormous losses incurred by FSLIC under the jurisdiction of the FHLBB is reason given for the conclusion reached by the Independent Bankers Association. However, the alternative regulatory structure does not appear to be a panacea. Witness the Ohio and Maryland S&L insurance fund collapses; in both instances, the insurer and the state regulatory agency operated in complete independence of the other. Witness the $4.7 billion in losses accrued last year by the FDIC, which operates independently from the Office of the Comptroller of the Currency. By comparison, the NCUSIF earned $43 million in 1988 after both operating expenses and losses. Furthermore, while FDIC and FSLIC closed down a record high number of institutions, NCUSIF set a record also -- a record low. One is hard-pressed to argue that NCUA/NCUSIF system is necessarily inferior to systems which have collapsed and have lost billions of dollars.

It does appear that the key to effective governmental supervision of depository institutions is comprehensive regulation. Rather than a system where the left hand knows not what the right hand is doing -- a system which provides for no internal checks and balances if one hand fails to perform its regulatory function correctly -- it seems from our experience that both hands working jointly towards the common goal of effective regulatory enforcement to guarantee safe and sound operations of the regulated is the preferred structure.

This is particularly the case where there are appropriate free market incentives favoring effective regulation. As stated earlier, federally insured credit unions have a vested interest in minimizing losses to the NCUSIF, and thus in effective credit union regulation. This vested interest takes the form of both positive and negative reinforcement. In the case of the former, if NCUSIF losses are minimized thereby permitting the fund's reserves to insured shares ratio to rise above 1.3 percent, credit unions are entitled to a rebate of all funds above that level, as occurred in 1985.

In the case of the latter, if losses to the fund ever caused the fund's ratio to drop to a level below 1.21 percent, the NCUA has the authority to assess what in effect would be a double premium; in addition to the interest earned on credit unions' deposits of the fund which are kept by NCUSIF -- which is an annual cost to credit unions in excess of what a 1/12 of one percent premium would be -- the NCUA has the authority to assess a premium of 1/12 of one premium to return the fund to its normal operating level. Furthermore, in the unlikely event that losses would continue to grow beyond this point to such an unprecedented and unforeseeable extent that the NCUSIF's ratio would drop below 1.0 percent, federally-insured credit unions would be required to send whatever funds were necessary to return the fund to 1.0 percent.

Not only do credit unions have a market incentive to minimize insurance fund losses -- one which would serve the FDIC and FSLIC well -- but credit unions as non-profit cooperatives are further distinguished from the thrift industry because they have no market incentive to engage in risky and questionable activities. The over-arching objective of the corporate manager -- by which the corporate manager is evaluated and from which all else flows, according to modern finance theory -- is to maximize the value of a firm's equity. Thus, the primary corporate goal is to maximize net income in order to keep the firm's stock value growing while paying on acceptable dividend to shareholders. When it became apparent in the late 1970's to managers of S&Ls with insufficient earnings that conservative, traditional lending practices did not afford them satisfactory returns, they sought to enter into riskier endeavors which would, if successful, provide greater returns. Unfortunately many of these endeavors failed, thereby exacerbating FSLIC losses.

Credit unions, because they are not driven by profit motivation, are immune from such pressures which caused the S&L industry to seek expanded, risky powers from legislators and regulators alike. Because the objective of a credit union is to provide basic, low-cost financial services to its members -- not profit-maximization -- credit unions are satisfied to engage in low-risk, traditional lending practices. These practices have not only served credit union members well, they have also served credit unions well, as the following comparative analysis of Texas depository institutions illustrates:

Texas Depository Institutions

Asset Quality: Problemed as a Percent of Total Assets

	1986	1987	1988
S&Ls	17%	23%	23%
Banks	3.2%	4.8%	5.1%
Credit Unions	1.4%	1.3%	1.3%

Return on Assets

	1986	1987	1988
S&Ls	-1.7%	-3.3%	-4.2%
Banks	1.3%	0.8%	0.1%
Credit Unions	1.3%	1.3%	1.2%

Solvency-Net Capital to Total Assets

	1986	1987	1988
S&Ls	-16%	-30%	-35%
Banks	4.4%	2.4%	1.7%
Credit Unions	5.3%	5.4%	5.2%

Q.5. Concerns have been expressed that credit unions now have very broad retail deposit taking and lending authority because recent regulations issued by the NCUA have made the "common bond" requirement meaningless. This, it is alleged, is demonstrated by the newly chartered AARP credit union which permits anyone over 50 years of age to qualify for membership.

*** Do you believe the "common bond" requirement needs to be strengthened if credit unions are to continue to receive favorable tax and regulatory treatment? If not, why not?**

*** If the Congress wanted to tighten the "common bond" requirement how would you recommend it do so?**

Answer 5: Subsequent to the chartering of the AARP Federal Credit Union, considerable concern arose from within the credit union community itself with regard to national field of memberships. As a direct result of this concern, the NCUA worked jointly with the credit unions it regulates to produce a new chartering manual for the agency. It is our belief that this new manual -- which appears in the Federal Reporter of March 24, 1989 -- embodies the concerns credit unions expressed regarding the common bond requirement. Further, it is readily apparent that under the guidelines of this new regulation, the chartering of another credit union with a field of membership comparable to that of AARP's is highly unlikely.

With regard to the "favorable tax and regulatory treatment" part of the question, we would like to make two points. First, credit unions are by no means under-regulated. Federally-insured credit unions -- unlike banks and S&L's -- are examined annually, have higher capital/asset ratios, and are extremely restricted in their lending and investing authorities. If this can be considered "favorable" regulation, we wonder whether banks and S&L's would support being similarly favored.

Second, the basis of the credit union tax exemption -- or any tax consideration -- is not the size, but rather the nature of the institution. The government does not exempt corporations from paying taxes because they are small, or tax big corporations because they are large. Rather, all firms which share a similar nature merely are taxed similarly because they are -- by their articles of incorporation -- independent, profit-making entities.

By contrast, credit unions are tax exempt because they are non-profit cooperatives. From the time of the Civil War, the nation's tax laws have generally treated cooperatives and other non-profit organizations as extensions of the membership of these organizations. Thus, the cooperatives' earnings have been taxed only when they pass to their members in the form of dividends. This appears to be the only reasonable basis on which this issue should be discussed.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM AL WILLIAMS

Question 1

The Administration's bill would require credit unions to write down over eight years the one percent of their insured deposits presently held in their insurance fund. The American Banker's Association has testified in favor of this proposal because, in its view, there is no reason why this one percent of money should be counted as capital for both the industry and its insurance fund. Mr. Rideout, the ABA witness, claims permitting this double counting creates a safety and soundness issue of significant dimensions because in a crisis the credit unions will lose one percent of their capital at the same time their insurance fund is going broke. How would you respond?

Answer

There are several points to be made in responding to Mr. Rideout's problem which questions what will happen to credit unions in a crisis situation i.e. one that might wipe out their fund.

First, the term double-counting carries with it an implication that the resources are actually less than being presented. The deposit in the Fund is treated the same as any deposit. In the Fund it is carried (1) as a liability and (2) as an investment in government securities. On the books of the credit union it is an asset along with loans and investments. If part of the 1% deposit had to be written down, it would fit in a "troubled assets" category. What is really being suggested by Mr. Rideout is that financial institution capital/asset ratios should be adjusted for "troubled assets." We are convinced that if banks and credit unions had to adjust their capital ratios for "troubled assets" credit unions would look even stronger then they do now. Even if we took off the entire 1%, our ratio would be about 6%. On the other hand, bank capital ratios would suffer dramatically from such a revision. Foreign debt alone, if treated the same as the 1% deposit for credit unions, would virtually wipe out all bank capital - from 7.95% to 0.95%

Second, our testimony on pages 10 and 11 provided details on the ability of our present system to meet and prevent a catastrophe. The credit union insurance system is based on the premise that maintenance of a high fund ratio comes first - even if it is costly to the individual institutions. The ABA finds fault with this approach by suggesting that it would be difficult for credit unions to replace the deposit all at once. From a public policy point of view, we fail to see why keeping a high fund ratio is not desirable. In order to protect the taxpayers, our system demands that institutions pay as you go. Reverting to the premium system would make adverse situations less costly for the financial institutions and more of a potential taxpayer liability because of extremely low fund ratios.

Third, our testimony on page 9 showed how remote the circumstances would be to ever require a write down of any of the 1% deposit. For example, insurance losses would have to rise to 260% of average losses before any of the 1% would ever be expensed. Further, since credit union assets are much less concentrated than banks, the failure of any single large credit union would not cause a significant write down of the 1% deposit.

Question 2

The ABA state in its testimony that since 1982 the average annual growth rate of credit union assets exceeded 17 percent and this fast growth has lead to increasing credit quality problems. It asserted that these credit quality problems are evident in the fact that loan losses at credit unions rose 64 percent from 1984 to 1987. Is it true that credit unions are experiencing an increasing percentage of loan losses and if so is that not an argument in favor of the Administration's proposal for raising their capital?

Answer

The following is a table showing credit union loan losses (charge-offs) since 1982. Please note the years chosen by the ABA to "manufacture" the "alarming" credit union trend.

Year	Net Loan Charge-offs Year End Loans Outstanding	
1982	0.56%	
1983	0.47%	
1984	0.36%	The 2 years chosen by ABA
1985	0.41%	
1986	0.57%	
1987	0.60%	
1988	0.58%	

Banks on the other hand have had a loans loss ratio of 1.1%, nearly double the credit union average loss ratio.

The ABA also implies that fast credit union growth has not been healthy. The following table details credit union growth from 1982-1988:

	(Annual Rate)
Savings	15.2%
Assets	15.2%
Loans	16.1%
Capital	16.6%

Note that capital grew faster than any other component. This growth in capital is after all loan losses. The capital-to-asset ratio rose from 6.8% in 1982 to 7.2% in December 1988.

To capsulize our position, we have prepared the following table showing percentage of loans with payments 2 months or more past due from 1980 to present.

Year	Percent of loan balances with payments 2 months or more past due	Capital/Assets
1980	3.3%	6.6%
1981	3.2%	6.9%
1982	3.8%	6.8%
1983	2.4%	6.9%
1984	2.0%	7.0%
1985	2.1%	6.9%
1986	2.2%	6.6%
1987	1.9%	6.9%
1988	1.8%	7.2%

The direction of both trends is clearly toward continued improved credit union health.

Question 3

The ABA testified that a credit union task force organized in March 1988, which included representatives of the credit union associations testifying today, concluded that the credit union industry needs higher capital standards. Is this true and if so why is not the Administration's proposal a fair way for the credit unions to achieve those higher capital standards?

Answer

The ABA is referring to the Report of the Credit Union Reserves Study Commission - February 1989. The Commission was formed to study what changes, if any, should be made in methods by which reserves and capital are accumulated and used by credit unions. A copy of this report has been sent to the Committee.

The purpose of the Commission was not to seek methods of increasing overall credit union capital. As previous answers demonstrated, credit union capital has been steadily increasing during this decade.

Rather the Commission was looking to the future to modernize and seek improvement in methods by which capital is accumulated. The ABA has totally misstated the mission and conclusions of the Reserves Study Commission.

Question 4

The Independent Bankers Association testified that the FSLIC crisis demonstrates that there is considerable danger in permitting one agency to both charter and insure financial institutions. The National Credit Union Administration does both. Do you believe Congress should separate NCUA's chartering and promotion functions from its insurance responsibilities? If not, how do you distinguish your industry from the thrift industry in this regard?

Answer

Regarding the S&L industry, the contention is being made that the industry had too much influence over the regulator and this put the FSLIC in jeopardy. We tend to agree with this assessment and separating these functions at the FHLBB is very likely a good way to break up the undesired relationships. However, we are not as convinced that a general principle can be drawn from this situation, that a separation of insurance functions in other agencies will automatically prove to be better than a combined function. The FDIC is an example of an independent insurer and its ratio has fallen to 0.83% and S. 413 is specifically designed to bring this fund up to par.

The NCUSIF on the other hand is an example of a combined function. In this agency, the insurance function drives the NCUA Board's policy decisions and supervisory functions. This is evidenced by the highest priority given to further capitalization of the Fund in 1984 and by the fact that the NCUSIF has by far the best insurance loss ratio of any of the federal funds:

Five-year Loss Average	FDIC	FSLIC	NCUSIF
Amount (millions)	$1,921	$6,148	$40
Per $1,000 Insurance Deposits	$1.29	$7.62	$.34

It seems to us that the theory behind separation of functions is that the insurer should be isolated from any undue influence which could develop because of the "close" relationship between the charterer/regulator and those being supervised. In this theory, powerful interests would manipulate the decision-making to their own personal advantage - at the possible expense of the insurance fund.

In the case of credit unions, much of the human incentive to manipulate is removed because of the non-profit structure of the credit union. It is difficult to construct a scenario which by the officials of a credit union could receive great financial gains, at the expense of the NCUSIF, because of their ability to influence NCUA.

Finally, we are concerned over the duplicative costs of two agencies and fear that one or both of these new smaller entities could more easily lose its independence. Such loss of independence could move credit union regulation and/or insurance under the control of larger bank-oriented agencies with little or no concern for preserving a unique credit union movement.

Question 5

Concerns have been expressed that credit unions now have very broad retail deposit taking and lending authority because recent regulation issued by the NCUA have made the "common bond" requirement meaningless. This, it is alleged, is demonstrated by the newly charted AARP credit union which permits anyone over 50 years of age to qualify for membership.

* Do you believe the "common bond" requirement needs to be strengthened if credit unions are to continue to receive favorable tax and regulatory treatment? If not, why not?

* If the Congress wanted to tighten the "common bond" requirement how would you recommend it do so?

Answer

First, credit unions do not have "broad retail deposit taking and lending authority." The AARP credit union is clearly an anomaly and the question seeks to generalize from it to deliberately paint an incorrect overall picture of credit unions.

Even a member of Congress would be rejected for membership in the vast majority of our nation's credit unions; I would estimate there are over 15,800 credit unions which a member could not join and for many others it would necessitate a change in the place of residence.

Membership is not "meaningless" to credit unions. It is the essence of the difference between a credit union and a bank. A credit union is formed around its member-owners and they are treated and participate as such. Because of this, surveys consistently find credit unions to be the most popular of all financial institutions.

With respect to the AARP Federal Credit Union it is our understanding that, under their existing guidelines, it would have been difficult for NCUA to reject the charter even though it was unusual in nature. The AARP situation evolved because a number of elderly citizens were unable to get the kind of financial services they wanted from banks. Because of this need, their association developed the concept of a credit union to serve them. Many felt that the elderly deserved some kind of special accommodation, but since we are being told that this charter is jeopardizing the tax exemption of every credit union in the country, this was clearly an incorrect assumption.

In any event, the NCUA is in the process of adopting a new manual on chartering and field of membership. The proposal appears in the Federal Register of March 24, 1989 and the comment period ends on May 23, 1989. As proposed, it would make it much more unlikely that a similar charter to AARP would be granted.

With respect to the second part of the question, there is no basis whatsoever for the assertion that credit unions receive "favorable" regulatory treatment. A credit union is a chartered financial institution and is fully regulated as such. Federal credit unions are examined more frequently than any other class of institution.

We do not believe on principle that the common bond needs to be strengthened to continue the present tax treatment. The tax exemption was originally based on the nature of the credit union not its membership. It stemmed from the not-for-profit cooperative nature of the credit union with its democratic control.

However, we are well aware that presently there are many members of Congress who have expressed a great deal of concern over certain isolated chartering practices. If these concerns do indeed jeopardize our tax exemption, then we obviously would prefer that Congress clarify its desires with respect to the common bond.

REPORT TO U.S. TAXPAYERS ON THE SAVINGS & LOAN CRISIS

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Report to U.S. Taxpayers on the Savings and Loan Crisis

Introduction

President Bush has finally recognized that there is a $100 billion deficit in the Federal Savings and Loan Insurance Corporation (FSLIC) that must be filled in order to protect insured depositors and place our system of federally insured depository institutions on a sound footing. A federal bailout of this magnitude is unprecedented, and must be subjected to rigorous scrutiny by the nation's citizens.

The FSLIC bailout should be guided by three broad principles. First, the bailout must be funded in an open, fair and efficient manner that does not hide costs, needlessly raise costs, or shift costs to persons who can least afford to pay. Second, the bailout must be accompanied by a fundamental reform of the regulation of federally insured depository institutions, otherwise the costly scenario of bank mismanagement and fraud and regulatory breakdown will repeat itself. Third, the 12 Federal Home Loan Banks, which were chartered by Congress in 1932 as public instrumentalities to serve housing credit needs, must be removed from the grasp of the S&L industry and given a new mandate to serve today's housing credit needs, especially those relating to housing for persons of modest means and local community development.

President Bush has proposed a plan for bailing out FSLIC, disposing of insolvent S&Ls, and revising the administrative structure of federal banking regulation. The President's plan is a step forward because it clearly recognizes the magnitude of the problem. However, the plan has a number of major flaws and crucial details are still unknown.

The Bush plan does not provide for sufficient new federal revenues to meet the cost of the bailout. This means that the bailout will exacerbate the federal deficit, crowd out important social spending, and ultimately be borne by taxpayers at large.

Whether the Bush plan will strengthen banking regulation depends on the precise nature of the reforms, but these have not yet been drafted. Prohibition of risky investment powers and tough new liability standards for misconduct by S&L and bank officers are essential. Merely shunting S&L regulation from one agency to another will not by itself accomplish reform.

The Bush plan fails to separate the Federal Home Loan Banks from the S&L supervision function and also fails to end S&L industry control over these vital housing finance vehicles. Giving the Treasury Department oversight authority over the Federal Homo Loan Banks without revising their mandate and control structure will do little to serve the housing credit needs of local neighborhoods.

i. Stronger Regulation of Insured Depository Institutions

a. Limit Expanded Powers

A major cause of S&L insolvency and the collapse of FSLIC has been the expansion of S&Ls in recent years into new investment activities, especially investment in real estate equity. Real estate equity investment is not only an inherently risky activity -- and thus inappropriate for federally insured depository institutions -- but, it also undermines a S&L's credit judgement in extending mortgage loans on properties where the S&L has a equity position and provides a potent incentive for real estate interests to take over S&Ls for purposes of self-dealing.

As early as January, 1987 FHLBB Chairman Edwin Gray warned Congress about the damage that the real estate equity investment power was wreaking in the S&L industry. Mr. Gray pointed to the performance of 33 California S&Ls which had made large real estate equity investments in the early 1980's. By 1986, five of these institutions had failed, one had merged, while the remaining 27 had an average net worth of 0.3% and an average return on assets of negative 3.3%.

One of the most vitally needed reforms is to prohibit S&Ls from engaging in real estate equity investment and other forms of direct investment. These investment powers, which even lie outside those available to commercial banks, should not be exercised by any type of federally insured depository institution. In short, S&Ls should not exercise lending and investment powers beyond those traditionally available to commercial banks. On the other hand, there is no reason to confine S&Ls to home mortgage lending. S&L diversification within traditional bank lending powers is useful to achieve portfolio balance and to manage interest rate risk.

Another flaw in the S&L regulatory structure has been the authority of state legislatures to grant broad investment powers to state chartered, but federally insured, S&Ls. The most expansive investment powers, especially in regard to real estate equity, have been granted to state chartered S&Ls by various state legislators, including those of Texas and California. The consequences for FSLIC and ultimately U.S. taxpayers of the permissive approach to S&L powers at the state level are quite shocking.

State chartered S&Ls represent 36% of the assets of FSLIC insured institutions, while federally chartered S&Ls contain the remaining 64% of such assets. Yet, looking at FSLIC insured institutions that are insolvent under generally accepted accounting principles (GAAP), state chartered S&Ls represent 58% of the assets of these insolvent institutions, while federally chartered S&Ls represent only 42% of such assets. More dramatically, the FHLBB calculated in October 1988 that state chartered S&Ls account for 81% of the collective negative net worth of GAAP-insolvent S&Ls, while federally chartered S&Ls account for 19% of this net worth deficit. Overall, the data indicate that state chartered S&Ls, which only represent slightly more than one-third of S&L industry assets, are responsible for about 80% of FSLIC's losses.

Clearly, Congress must prohibit state chartered S&Ls as well as federally chartered S&Ls from undertaking real estate equity and other non-banking investments. A regulatory structure under which the federal government insures the deposits of state chartered S&Ls while state legislatures have carte blanch to grant broad investment powers to these institution is not a creative exercise in federalism but a license to steal from U.S. taxpayers.

The failure to limit the activities of unitary S&L holding companies poses another major threat to the safety of the federal deposit insurance system. The Savings and Loan Holding Company Act is a legislative sieve that imposes virtually no limits on the acquisition of unitary S&Ls by non-financial firms. Corporations engaged in a broad range of economic activities -- real estate development and brokerage, manufacturing, retailing, as well as investment banking and insurance -- can and have taken over S&Ls and manipulated them for various corporate purposes. William Black, Deputy Director of FSLIC, graphically described this danger in testimony prepared for House Banking Committee Hearings on June 9, 1987:

> The change of control often brought a real estate developer into control of the thrift. For the unscrupulous developer, owning a thrift was a dream come true -- a virtual printing press to provide money to develop his real estate.

At the eleventh hour, Mr. Black's testimony was quashed by House Banking Committee Chairman Fernand St Germain and never presented to the committee.

In sharp contrast to the Savings and Loan Holding Company Act, the Bank Holding Company Act imposes important limitations on the ownership of commercial banks by non-financial corporations. Any reform legislation should extend the Bank Holding Company Act to cover S&Ls and jettison the S&L Holding Company Act as a relic of an over indulgent S&L regulatory structure that can no longer be tolerated.

b. Greater officer and director liability for misconduct

The GAO has been conducting an extensive investigation into the causes of S&L and bank failures. Although FSLIC's $100 billion insolvency is the paramount issue of the today, concern about commercial bank failures is warranted. Over the 1987-1988 period 424 commercial banks failed, and the FDIC anticipates that its insurance fund will show a $3 billion to $4 billion loss for 1988. The most striking finding of the GAO investigation, which was reported to the House Banking Committee in January of this year, is the critical role of management misconduct -- fraud, insider abuse, and violations of law -- in recent S&L and commercial bank failures.

Much attention has been focused on the historic mismatch between long-term assets and short-term funds in S&Ls and the downturn of the Southwest economy as the principal causes of recent S&L and bank failures. Yet, GAO reports that well-managed banking institutions have remained viable despite downturns in their local economies. More dramatically, after reviewing 26 S&L failures and 184 commercial bank failures, GAO found in virtually every case a failure by management to establish and maintain adequate controls or as GAO phrased it "a breach of [management's] fiduciary duty to operate a financial institution in a safe and sound manner."

Specifically, GAO found management fraud or insider abuse in 100% of S&L failures and 64% of commercial bank failures. The S&L failures were characterized by extensive and repeated violations of law. At 77% of failed S&Ls, there were conflict of interest problems, while allegations of criminal misconduct were found at 73% of failed S&Ls.

Moreover, GAO also determined that the managements of the failed financial institutions had not been responsive to the recommendations and directives of the regulators. At failed commercial banks the responses were often delayed or inadequate, while some S&L managements were "astoundingly egregious in ignoring or circumventing regulators."

GAO's findings on the central role of bank management misconduct are similar to those of the banking agencies and the Congress. For example, a 1988 review by the House Government Operations Committee of FHLBB data for 210 S&Ls that failed during the January 1984-June 1987 period revealed that the FHLBB had identified misconduct at 80% of these institutions. A 1988 study by the Comptroller of the Currency of 171 national banks that failed during the 1979-1987 period found that insider abuse was a significant factor in 35% of the failures.

These government investigations evidence a shocking pattern of greed and lawless behavior by officers of banking institutions that rivals the financial misconduct of the late 1920's as revealed in the 1933 Pecora Hearings, such as the misdeeds of National City Bank's Charles E. Mitchell and Chase National Bank's Albert H Wiggin. The crux of reforming banking regulation is to instill a greater discipline in bank management and the most effective means to this end is to expand the scope of their civil and criminal liability for misconduct.

Senior officers and directors of a federally insured depository institution should be held liable for misconduct that leads to institution failure under a more rigorous set of civil and criminal liability provisions. In the event of failure, individual shareholders in the S&L or bank and uninsured depositors should have standing to bring direct suit against bank officials. The existing private remedy of derivative stockholder suits is cumbersome and often ineffective, and the banking regulators often fail to pursue available civil and criminal remedies.

Once a civil or criminal suit for misconduct has been filed, the court should have clear authority to issue a pre-trial freeze order to prevent dissipation of assets by the defendants. Misconduct should be defined to include fraud, negligence, or self-dealing that contributes to the failure of the bank. Such strict liability for self-dealing is appropriate, given that self-dealing has been found to be an important cause of bank failure and is ab initio suspect under fiduciary concepts. Finally, private plaintiffs and the government should be authorized to recover treble damages in bank misconduct suits.

Prohibiting S&Ls from making speculative investments (real estate equity and other direct investment in non-banking activities) and expanding management liability for bank misconduct are vital tandem reforms. Evidence from recent S&L failures indicates that the authority to engage in speculative investments interacts with the proclivity toward misconduct to produce management decisions that are lethal to bank safety. In 1987 FSLIC testified before the House Government Operations Committee that "Combined, these two causes of losses [insider abuse and fraud and risky investment strategies] are overwhelmingly responsible for virtually all recent failures, FSLIC's growing insolvency, and the huge coming losses that we have already identified."

c. More regulatory discipline

1. Early closure

An additional set of regulatory reforms are necessary to stiffen the will of the banking regulators to take timely action against problem banking institutions and to provide better information to the public on the condition of federally insured banking institution. The regulators should be required to operate under an early closure rule that would direct them to close or merge a failing institution before not after it reaches the point of insolvency. If FDIC or FSLIC "resolves" a failing institution before it becomes insolvent on a market-value basis, then there will be no loss to the insurance fund.

Yet, when banking institutions begin to slide towards failure, they are often able to exert enough political pressure on their regulator to obtain forbearance. In fact, a 1986 study by FHLBB economists found that during the 1980's FSLIC had been following a closure rule that on average delayed agency action until one full year after GAAP insolvency, an approach that guarantees that FSLIC will incur large losses.

To safeguard the deposit insurance funds, Congress should require an early closure rule based on an institution's market-value or GAAP value, not the lax regulatory accounting rules (RAP) that banking regulators have devised. To the extent feasible, the market-value test should be used in preference to the GAAP value test, because GAAP itself is book value accounting that does not measure the current market value of assets.

2. Runaway deposit growth

A frequent scenario leading to deposit institution failure is a pattern of explosive deposit and asset growth by thinly capitalized institutions pursuing high risk investment strategies. This runaway institution phenomenon -- which is possible only because of deposit insurance and, at least for larger institutions, the implicit promise of full bailout -- has proved exceedingly costly to FSLIC. Given the mounting severity of capital inadequacy in the S&L industry during the 1980s, it was inexcusable for the FHLBB to permit deposits at S&Ls to escalate from $499 billion at year-end 1980 to $933 billion by year-end 1987, a 7 year growth rate of 187%. Congress should explicitly empower and direct the banking agencies to impose deposit growth ceilings on insured institutions that do not meet GAAP-based or market-value capital requirements.

3. Accounting practices

More generally, accounting legerdemain in the form of RAP accounting has been one of the principal mechanisms used by the FHLBB to mask S&L insolvency and postpone FSLIC's day of reckoning. This refusal to recognize losses has caused the FSLIC deficit to escalate from perhaps $15 billion in the early 1980's to $100 billion today. To prevent a repeat performance in future years and more generally in the interest of honest accounting procedures Congress should require the banking agencies to reform their accounting rules for banking institutions. Specifically, the agencies should be directed to apply market-value accounting rules to the maximum extent feasible or GAAP rules. RAP rules should be assigned to the growing trash bin for

regulatory indulgences that will no longer be tolerated by taxpayers who stand behind the federal deposit insurance funds.

The banking agencies collect extensive balance sheet and income statement data on a quarterly basis for each federally insured depository institution. These quarterly reports, known as condition reports, contain important information concerning an institution's portfolio composition, interest rate risk, and operating costs. Unfortunately, only portions of these condition reports are made available to the public. For example, the condition report that the FHLBB requires from S&Ls contains 610 data items, but the FHLBB releases only 231 of these items to the public. Full public disclosure of condition report data should be an automatic -- and hardly controversial -- condition of access to federal deposit insurance. To overcome the agency inclination to shield banking institutions from public disclosure, Congress should mandate full disclosure of condition reports.

d. Problems inherent in a rollback of deposit insurance

Some proponents of financial deregulation have called for a rollback in the scope of federal deposit insurance with its current ceiling of $100,000 per deposit account in order to impose more market discipline on the activities of insured banking institutions. At year-end 1987, 34% of total deposits in FDIC insured banks were uninsured (accounts over $100,000), while less than 10% of the deposits in FSLIC insured institutions were uninsured.

Although plausible at first blush, this approach to reforming banking regulation has a number of troublesome aspects. The root causes of banking failure -- management misconduct and excessive risk on certain (usually non-standardized) loans and investments -- are not readily discernible in bank financial statements and can deeply erode an institution's capital well before the situation is discernible to even sophisticated public investors. Thus, a rollback in federal deposit insurance -- especially one coupled with greater willingness on the part of the federal regulators to leave uninsured depositors fully exposed when institutions fail -- could lead to situations in which the rumor of potential problems could trigger rapid deposit outflows at a bank. This could destabilize problem banks, thereby compounding the supervisory task of the regulators, and might even injure some perfectly healthy banks.

More generally, any pronounced rollback in federal deposit insurance or effort to "privatize" deposit insurance could have significant adverse impacts on the availability of credit for local community development and small business. If depositors or private insurers must evaluate bank or S&L portfolios in order to safeguard their funds or control their insurance liability, they will want to deal with banking institutions that hold only very standardized loans. Non-standardized credits, which are the lifeblood of small business, housing rehabilitation, and other small-scale local community development endeavors, are costly on a per dollar of assets basis for third parties to evaluate. In fact, this information obstacle already prevents banking institutions from originating such non-standardized loans and then "securitizing" or reselling them into secondary markets.

Moreover, "privatization" of deposit insurance would most likely merely transform the problems of banking regulation into problems of insurance regulation, rather than obviate the need for government regulation. In essence, the state-level insurance guarantee funds would become the new deposit insurance agencies. Depositors, local community borrowers, and ultimately taxpayers who want strong banking regulation are better off seeking banking reform from Congress than becoming trapped in the quagmire of state insurance regulation.

What is needed far more than market discipline is a strong dose of structural discipline, fiduciary discipline, and regulatory discipline. Structural discipline will place excessively risky powers, such as real estate equity investment, off-limits to S&Ls and other banking institutions. Fiduciary discipline will internalize in managements of financial institutions a much greater awareness of the need for honesty, prudence, and restraint in self-dealing. Regulatory discipline -- a stronger mandate for action on the part of the regulators -- will work to protect the government deposit insurance funds by curbing losses before they begin to escalate.

II. Greater Public Accountability for Banking Regulators

a. Financial consumers' associations

A clear lesson of the FSLIC debacle is the great potential for regulatory failure at agencies charged with regulating depository institutions -- not just regulatory mismanagement, but also misrepresentation to the public of the real condition of financial institutions. S&L depositors in Maryland and Ohio felt the full sting of such regulatory failure in 1986 when the state insured S&Ls in those states collapsed. As for FSLIC, not until the very end of 1988 -- after Vice President George Bush had successfully completed his campaign for the Presidency -- did FHLBB Chairman Danny Wall publicly admit that FSLIC required additional public funds. Furthermore, such regulatory obfuscation and outright misrepresentation provides a convenient pretext for legislative inattention.

In the long run the only effective antidote to regulatory failure and legislative inaction is a more vigorous watchdog role by consumer organizations with enhanced expertise in financial service regulation. To this end, Congress should enact legislation that would facilitate the establishment in each state of a consumer controlled, self-funded, but publicly chartered financial consumers' association. The legislation would direct federally insured depository institutions to insert in their deposit account statement mailings to consumers a statutory notice informing the consumer of his or her right to join the association. In December 1988 the Senate Banking Committee held hearings that produced a strong record of support by consumer groups for the financial consumers' association concept.

b. Congressional access to banking agency documents

The House Banking Committee has encountered strong resistance and extended delays in obtaining from the FSLIC assistance agreements and other documents concerning failing S&Ls. Given the massive taxpayer liability that underlies these transactions, the inability of Committees of Congress to obtain prompt access to these documents is inexcusable. Reform legislation should give Congress direct access to all FSLIC and FDIC assistance agreements and all supervisory documents concerning federally insured institutions that fail to meet regulatory net worth requirements.

III. Revamping the Federal Agency Structure of S&L Regulation

GAO stated in January 1989 testimony before the House Banking Committee that there is a "basic structural flaw" in the Federal Home Loan Bank System: its "dual and conflicting responsibilities for promoting the thrift industry while at the same time supervising and regulating it."

The inherent conflict of interest that has undermined the Federal Home Loan Bank System has two aspects. First, the 12 Federal Home Loan Banks, which play a major role in examination and supervision activities, are controlled by the S&Ls that they are supposed to regulate. Second, the S&L industry has exercised inordinate influence over the FHLBB in large measure because the FHLBB has a mandate to promote housing -- easily construed to mean the interests of the S&L industry -- as well as a mandate to supervise federally insured S&Ls for safety and soundness purposes.

Dan Brumbaugh, who served as the FHLBB's deputy chief economist from 1983 to 1986, has aptly described the consequences of this structural flaw in his recent book, Thrifts Under Siege:

> It is difficult not to conclude that, by a combination of direct and indirect avenues, primarily through the Federal Home Loan Banks and trade associations, the thrift industry has heavily influenced the regulatory policy since the 1930s. Without doubt, the degree of this influence has exceeded what is necessary to assure that relevant industry expertise finds its way into regulatory deliberations. To those steeped in the capture theory of regulation, however, it is not surprising to find that what appears to be the most regulated industry also appears to have the greatest influence over its regulators. The result in the 1980s has been the selection of regulatory approaches that have favored the short-term interests of existing thrift institutions at the expense of consumers of financial services, society in general, and even the long-term interests of stockholders and employees of those thrift institutions that will ultimately survive.

a. Conflicts of Interest at the Federal Home Loan Banks

The Federal Home Loan Bank System is comprised of (1) the Federal Home Loan Bank Board (FHLBB), (2) the FHLBB's two operating subsidiaries, FSLIC and the Federal Home Loan Mortgage Corporation (FHLMC), and (3) the 12 Federal Home Loan Banks. The Federal Home Loan Banks embody the most serious structural conflict of interest in the system. Under the Federal Home Loan Bank Act of 1932 the S&Ls from each Bank District elect a clear majority of the directors of their Federal Home Loan Bank. Most Federal Home Loan Banks have 14 directors, and S&Ls elect 8 of these directors. Under this statutory scheme, the directors of a Bank employ, set the salary of, and dismiss at pleasure the president of the Bank and its senior officers. Although the FHLBB has collateral authority to remove a Bank officer, the senior management of a Federal Home Loan Bank is nonetheless a creature of the Bank's board of directors and, indirectly, of the S&Ls within the Bank's District.

Moreover, S&Ls have a proprietary interest in the Federal Home Loan Banks which reinforces their control via election of Bank directors. All of the stock of a Federal Home Loan Bank -- which for all 12 Banks had a consolidated book value of

$13.7 billion at year-end 1987 -- is owned by the S&Ls within the Bank's District.

The Federal Home Loan Banks exercise a range of supervisory activities over S&Ls and conduct other operations that have a direct bearing on S&L safety and soundness. Most important, the president of each Bank serves as the FHLBB's "Principal Supervisory Agent", the chief S&L supervisor for S&Ls within the Bank's District. Assigning such a key supervisory function to an official who holds office at the pleasure of the S&Ls that he or she is suppose to regulate is obviously a fundamental conflict of interest. An extensive examination of the S&L industry and S&L regulation commissioned by the FHLBB, Study of the Savings and Loan Industry (1969), forewarned of this conflict in its conclusion that: "Because the supervisory agent is an officer of the Bank, and therefore elected by a board dominated by industry members, there appears to be some feeling that his judgment is not entirely objective."

The supervisory activities of the officers of the Federal Home Loan Banks are critical from a number of perspectives. Most important, they involve taking action -- or failing to do so -- when examiners have uncovered unsafe conditions or violations of law at an S&L. Bank officers play a key role in monitoring problem S&Ls and providing advice to FSLIC on the negotiation of assisted mergers. Beginning with a 1980 report and continuing through its present investigations, GAO has observed systemic weakness in the supervisory actions of the Federal Home Loan Bank System: timidity in initiating supervisory action; failure by S&Ls to act on supervisory recommendations; and reluctance to take formal action in the face of S&L foot-dragging or blatant disregard of supervisory recommendations. Without doubt, the close relationship between the Banks and the S&Ls they regulate has been a primary factor underlying what GAO has described as a breakdown of the supervisory and regulatory system.

Moreover the officers of Federal Home Loan Banks have other important policy roles that impact on S&L safety and soundness, and thus entail further conflicts of interest. Under the FHLBB's rules governing S&L direct investment powers, they exercise important discretion in determining the scope of permissible activities. They have been delegated authority by the FHLBB to act on various types of expansion applications. They also have a major role in determining whether real estate appraisals are adequate. Further, they directly control activities of the Banks -- in particular, cash advance lending to S&Ls and interest rate swap programs operated for the benefit of S&Ls -- that can have a vital impact on the financial condition of individual S&Ls.

Finally, the institutionalization of conflict of interest in the structure of the Federal Home Loan Banks has signaled the S&L industry that self-dealing is permissible and created a regulatory culture that is tolerant of self-dealing. Yet, all studies of S&L failures have identified self-dealing as a key cause of failure in the S&L industry.

The structural conflict of interest inherent in assigning supervisory responsibilities to Federal Home Loan Bank officers was exacerbated in 1986 when the FHLBB placed the Bank officers in direct control of S&L examiners and transformed the examiners into employees of the Banks. FHLBB Chairman Edwin Gray in testimony before the House Banking Committee in June, 1986 somewhat euphemistically referred to this delegation of the examination function to the Federal Home Loan Banks as allowing "maximum responsiveness to the needs of the industry we regulate."

FSLIC's recent attempts to deal with insolvent S&Ls in Texas provide a classic illustration of the conflict of interest inherent in allowing S&L officials to serve as directors of the Federal Home Loan Banks. In May, 1988 FSLIC provided a record $2 billion in assistance to Southwest Savings Association, Dallas to acquire four insolvent S&Ls. Southwest's top executive, C. Todd Miller, was the vice chairman of the Federal Home Loan Bank of Dallas. At the time that FSLIC extended the $2 billion package to Southwest Savings, FHLBB member Roger Martin stated that Southwest "provides good management" for the insolvent institutions. Yet, only four months later Martin stated publicly that the FHLBB was "very disappointed with the progress [Southwest's officers] have made" and complained that Southwest "hasn't been aggressive" in acting on FHLBB directives to cut overhead, streamline operations, and put a lid on deposit interest rates.

In 1988 S&Ls from the Dallas District nominated as candidates for election to the board of directors of the Federal Home Loan Bank of Dallas 3 officers from 3 problem Texas S&Ls. In recent years a number of Federal Home Loan Bank directors have been top officers of S&Ls that have either collapsed or been seriously weakened by unsound lending practices.

S&L industry control over the Federal Home Loan Banks creates conflicts of interest in regard to the use of Bank resources, as well as in the supervisory area. For example, in December 1988 the Federal Home Loan Bank of Indianapolis sent a letter to S&Ls in its District calling attention to the opportunity to borrow from the Bank's cash advance facility in order to dress-up their balance sheets. Unabashedly, the letter stated, "As in years past, we anticipate that many institutions will want to fine-tune their statements by using short-term advances as 'window-dressing.'"

b. Conflict of interest inherent in the FHLBB's housing promotion mandate

Marriner Eccles, Chairman of the Federal Reserve Board from 1934-1948, has described in his book Beckoning Frontiers (1951) the difficulties he encountered in keeping Morton Bodfish, chief lobbyist for the powerful Building and Loan League (predecessor to the U.S. League of Savings Institutions), out of the drafting sessions of Roosevelt Administration officials that led to the National Housing Act of 1934. In addition to creating the Federal Housing Authority (FHA), that Act established FSLIC, thereby extending the system of federal deposit to savings and loans. Moreover, with remarkable prescience Eccles observed:

> ... in later years all the protective provisions that were agreed to for the purpose of creating adequate reserve funds in the insured institutions as well as adequate reserve funds in the new insurance corporation were either weakened or eliminated under the lobbying pressure that Bodfish effectively directed.

In 1986, as the savings and loan system began to unravel and FSLIC slid into insolvency, former FSLIC director Peter Stearns noted the same pattern of inordinate S&L industry influence over the FHLBB. According to Stearns, "The Bank Board doesn't regulate anything unless the U.S. League and the top S&Ls agree."

The unique power of the S&L industry to influence the policies of the FHLBB and indirectly the decisions of Congress is rooted in the FHLBB's dual mandate to promote

housing and regulate insured S&Ls. The S&L industry doesn't employ a more skilled cadre of lobbyists or operate with a larger war chest of PAC funds than other financial sectors, such as the commercial banking industry or the insurance industry. What the U.S. League has done skillfully is to wrap itself in the mantle of housing and exploited the political appeal of housing to obtain a continuing series of special exemptions, privileges, waivers, and indulgences that have loosened S&Ls from the regulatory constraints generally imposed on federally insured depository institutions. The authority of S&Ls to engage in risky investment activities, such as real estate equity investment, through service corporations or directly in the case of some state chartered S&Ls is a prime example of this phenomenon. Another is the authority for non-financial firms, such as real estate developers or insurance companies, to acquire S&Ls under the S&L Holding Company Act.

Moreover, the housing mantle has definitely been a factor contributing to the failure of Congress to direct FSLIC to close down insolvent S&Ls before their losses escalated to the point of creating a $100 billion taxpayer liability. The Garn-St Germain Act of 1982, which sought to disguise the loss of capital at many S&L with paper net worth certificates, reflected a desire to keep as many struggling housing lenders afloat as possible, as well as federal budget constraints that weighed against authorizing real funds to dispose of these institutions. In fact, the Act even went so far as to prohibit the FHLBB from requiring problem S&Ls as a condition for receiving net worth certificates to agree to make management changes or to merge with a healthy institution.

In 1987 many members of Congress, including House Speaker Jim Wright, vigorously opposed the Treasury Department's proposal to provide $15 billion to FSLIC to resolve insolvent S&Ls. The driving force behind this effort to minimize FSLIC's resources was once again the desire to buy more time for failing S&Ls. The FSLIC Recapitalization Act of 1987 authorized only $10.8 billion for FSLIC and these funds could only be drawn down over a three year period. The legislation also contained an explicit waiver from certain GAAP accounting rules for S&Ls.

c. A new structure for S&L regulation

A number of agency structure reforms are needed to establish adequate safety and soundness regulation of S&Ls and minimize future liability on the part of U.S. taxpayers for regulatory mismanagement.

First, all activities relating to the examination and supervision of S&Ls should be completely divorced from the 12 Federal Home Loan Banks. The mandate of these institutions is to serve housing credit needs, not to engage in safety and soundness regulation; and, further, it is foolhardy to give then even a tangential role in safety and soundness matters in view of their domination by S&Ls.

Second, FSLIC should be incorporated within the Federal Deposit Insurance Corporation, as President Bush and the GAO have proposed. This consolidation makes sense from the point of view of administrative efficiency, agency resources, and minimization of conflicts of interest.

Third, the FDIC should be given authority to set general safety and soundness standards (capital requirements, accounting rules) for all federally insured S&Ls. This transfer of authority should take place regardless of what happens to the FHLBB's other functions. Again, both President Bush and the GAO have recommended this course of action.

Fourth, a major policy question arises as to where the authority to charter federal S&Ls and to examine and supervise all federally insured S&Ls should be lodged. A good case can be made that all examination and supervisory activities should be assigned along with the deposit insurance function to the FDIC. All too often bank examiners from the FHLBB and OCC -- agencies with the promotional chartering mission -- have uncovered unsound banking practices, but their immediate supervisors have failed to act vigorously on the examiners' recommendations. In fact, much of the weakness in both S&L and commercial bank regulation reflects a lack of agency will to use their existing supervisory powers, rather than failure on the part of examiners to uncover unsafe and unsound banking conditions.

Thus, one approach would be to assign all S&L examination and supervision functions to the FDIC and downgrade the FHLBB to the status of a promotional and chartering Office of Savings and Loans within the Treasury Department. A second approach would be to leave the FHLBB with chartering, examination and supervision powers over federally chartered S&Ls in a manner that parallels the authority of the Comptroller of the Currency (OCC) over national banks. In this case, the FHLBB could either remain as an independent agency or be incorporated within Treasury. A third approach would be to leave the authority to examine and supervise state chartered S&Ls, as well as federally chartered S&Ls, within the FHLBB, either as an independent agency or as a Treasury office.

A fourth and preferred approach would be to leave the authority to examine and supervise S&Ls within the FHLBB, but to require the automatic transfer of this authority to FDIC whenever an S&L falls below the regulatory capital standard or is found to be operating in an unsafe or unsound condition. Moreover, this principle of transferring full authority over problem institutions to the FDIC should also be extended to the regulation of national banks.

Finally, the question of whether FHLBB should retain independent agency status or be subsumed within the Treasury Department should be determined by the future role envisioned for S&Ls. As discussed below, S&Ls should be given the same lending powers as commercial banks and allowed to decide individually the extent to which they will specialize in mortgage lending. Thus, the best course would be to establish within the Treasury Department a banking office that would issue an all-purpose federal bank charter that would replace the separate charters currently issued for national banks, federal S&Ls, and federal savings banks.

IV. The Changing Structure of the Mortgage Market and the Future Role of Savings and Loans

a. Restructuring the mortgage market

Throughout most of the post-War era S&Ls have served as the nation's predominant residential mortgage lenders. By 1977, S&Ls held in their portfolios 44.6% of the nation's outstanding stock of residential mortgage loans, and during that year accounted for 52.4% of all residential mortgage loan originations. Yet, over the last decade the role of S&Ls in the mortgage market, both as originators and as portfolio investors, has declined dramatically. At year-end 1987 S&Ls held in their portfolios only 26.9% of the nation's stock of residential mortgage loans, and S&Ls accounted for only 38.8% of residential mortgage loan originations.

At the same time that S&Ls have declined, the mortgage market has been dramatically transformed by the introduction of financing techniques that convert mortgage loans into securities. In 1977 only 14.6% of 1-4 family mortgage loan originations were "securitized", but this figure had grown to 54.8% by 1987. Mortgage securitization, by directly linking the mortgage market and the capital market, has encouraged major capital market investors, such as pension funds and insurance companies, to expand their investment in mortgage credit.

Moreover, the strong demand in the capital market for mortgage-backed securities has encouraged many lenders who are unable or unwilling to hold mortgages on a permanent basis in their portfolios to become more active as mortgage loan originators. For example, the share of residential mortgage loans originated by mortgage companies and commercial banks rose from 37.5% in 1977 to 49.5% in 1987. By enlarging both the number of originators and the number of ultimate investors, the restructuring of the mortgage market has provided, in general, an adequate supply of mortgage credit, notwithstanding the declining role of the S&L industry.

Of course, the traditional problems of discrimination in mortgage lending and redlining still remain: and there has been an unconscionable failure by our society to provide an adequate supply of housing for lower income persons; and today serious affordability obstacles are encountered even by middle income first-time home buyers. However, these housing problems are the product of continuing lender prejudice and the distorted budget priorities and manifest fiscal irresponsibility of the Reagan era, not a consequence of mortgage market restructuring or the decline of S&Ls. For the affluent, the mortgage market has been booming: and as housing prices continue to escalate, a serious question exists as to whether too much of the savings of our nation's families is being funneled into luxury housing equity instead of being invested in education and industry to improve the productivity and competitiveness of our economy.

b. The future of S&Ls

Reliance on S&Ls as mortgage specialists is not only unnecessary in light of the restructuring of the mortgage market, but also an unsound policy from the perspective of maintaining the safety and soundness of insured depository institutions. Charter requirements that forced S&Ls to specialize in holding mortgage assets resulted in the negative spreads and large-scale losses that weakened many S&Ls in the early 1980's. Given the potential for interest rate instability that characterizes our financial markets, S&Ls can prudently hold a high proportion of their assets in residential mortgage loans only if the loans are adjustable rate mortgages that permit rapid rate increases. In fact, so many S&Ls have limited their portfolio acquisitions to exclusively adjustable rate mortgages in recent years that by year-end 1987 54% of the 1-4 family mortgage loans held by FSLIC insured S&Ls were adjustable rate mortgages.

However, a national policy encouraging the use of adjustable rate mortgages is both undesirable and unnecessary. It is undesirable because it shifts interest rate risk to home buyers. Although adjustable rate mortgage may be useful in some circumstances, for the majority of home buyers they are a time bomb waiting to detonate whenever there is a sharp and prolonged escalation of interests rates. Moreover, primary reliance on adjustable rate mortgages is unnecessary because many capital market investors, such as pension funds and insurance companies, seek long-term, fixed rate investments and thus are in a good position to purchase securities collateralized by pools of long-term, fixed rate mortgages. Thus, from several perspectives -- bank safety, home buyer interest, and financial efficiency -- national mortgage market policies should encourage the linking of the mortgage origination process to the capital market via securitization, rather than forcing S&Ls to hold a high percentage of their assets in residential mortgage loans.

S&Ls should be permitted -- with vigorous oversight to prevent future debacles in commercial mortgage lending -- to diversify their assets within the boundaries of traditional commercial bank lending authority. In fact, the diversification process has already begun at many S&Ls. As recently as year-end 1977, S&Ls collectively held 74.4% of their total assets in residential mortgage loans. By year-end 1987 this percentage had fallen dramatically to 45.9%. On the other hand, during the same 10 year period the share of S&L assets invested in mortgage-related securities rose from 2.8% to 16.1%. Thus, the increase in mortgage-related securities offset less than one-half of the decline in mortgage loan holdings.

From year-end 1980 to year-end 1987 the total assets of the S&L industry grew from $615.3 billion to $1,250.9 billion. Only 20.2% of this massive $635.6 increase in S&L assets was invested in residential mortgage loans, and another 27.5% was invested in mortgage-related securities.

The degree of specialization in mortgage lending should be a decision left to managements of individual S&Ls. Undoubtedly, given their expertise in the mortgage area, many will choose to continue to emphasize mortgage lending. Their charter authority, however, should be no less than -- but, also no greater than -- the charter authority of commercial banks. The unmistakable conclusion is that there is no underlying public purpose in maintaining separate charters for commercial banks and S&Ls.

V. A New Mandate for the Federal Home Loan Banks to Address Today's Housing Finance Needs

a. The Federal Home Loan Banks: Public Purpose Institutions

The Federal Home Loan Bank Act of 1932 authorized the establishment of the 12 Federal Home Loan Banks. The underlying purpose of the Banks was to enhance and stabilize the flow of residential mortgage credit by lending cash advances to S&Ls. The Banks are federally chartered corporations and by federal statute they have a $4 billion line of credit from the Treasury Department. The fact that the federal government stands behind these Banks has enabled them to borrow massive sums at preferred interest rates, lend the funds as cash advances to S&Ls, generate robust income, and build a substantial capital base.

At year-end 1987, the Federal Home Loan Banks had raised $116 billion (outstandings) in the capital market by issuing consolidated bonds and notes and had lent $133 billion (outstandings) in cash advances to S&Ls. The combined equity capital of the Banks was $13.7 billion at year-end 1987 and their combined net income for 1987 was $1.328 billion.

Even though S&Ls elect a majority of the Federal Home Loan Bank directors and hold the capital stock of the Banks, the Banks are clearly public purpose instrumentalities. As the U.S. Court of Appeals for the Ninth Circuit held in Fahey v. O'Melveny 200 F.2d 420 (1952), "the Federal Home Loan Banks are not 'private property' of their member-stockholders but are banking agencies and instrumentalities of the federal government."

b. Diversion of the Federal Home Loan Banks from public purpose to private use

The direct control exercised by S&Ls over the Federal Home Loan Banks not only has resulted in serious conflicts of interest in regard to the supervision of S&Ls but also has diverted the Banks from their intended role as public institutions serving housing credit needs identified by public policy. The current operation of the cash advance program is the most compelling evidence of how far the Banks have slipped from their intended purpose of serving mortgage credit needs.

Cash advances can provide a useful tool to stimulate housing loans and other community development lending because they provide S&Ls with longer term, stable rate funds and also because the preferred rate at which the Banks raise funds can to some extent be passed along to S&Ls borrowing cash advances. Yet, a 1988 GAO study of the cash advance system could not identify any significant way in which this massive funding system was serving housing credit needs. The FHLBB and the Banks allow S&Ls to use cash advances to fund any kind of lending or investment activity. GAO found that as of year-end 1986 for the 54.8% of S&Ls that had cash advances outstanding, mortgage loans on 1-4 family homes represented 47.40% of their combined assets; while for S&Ls without cash advances outstanding, 1-4 family mortgage loans comprised 48.22% of their total assets -- a statistically insignificant difference. Moreover, S&Ls with cash advances tended to use new lending and investment powers more aggressively than S&Ls without cash advances.

One plausible public rationale for the cash advance system is that it can provide smaller S&Ls, who may lack the ability to issue their own debt securities, access to longer term funds. Yet, GAO found that cash advances were used predominantly by large, aggressive S&Ls, not smaller institutions. For example, at year-end 1986 only 35% of S&Ls with assets less than $100 million held cash advances, while 95% of the 207 S&Ls with assets over $1 billion held cash advances. In fact, 45 S&Ls with assets over $1 billion from the Federal Home Loan Bank of San Francisco District held $32 billion in cash advances -- 30% of the entire volume of cash advances outstanding.

GAO also found a clear correlation between use of cash advances and the financial condition of S&Ls. At year-end 1986 S&Ls with cash advances had an average net worth of only 3.4%, compared to 4.8% for S&Ls without cash advances. In the Federal Home Loan Bank of Dallas District, cash advance users had an average net worth of -0.1%, compared to 3.2% for non-users. The GAO study suggests that the cash advance system has been administered by the Banks in a manner that not only fails to serve current mortgage credit needs, but also has weakened safety and soundness discipline at many S&Ls.

While the Federal Home Loan Banks seem to have had little positive impact in serving mortgage credit needs, they have been a very efficient cash generating machine for the S&L industry. For example, over the three year period from 1985 through 1987 the Banks had a cumulative net income of $3.9 billion and paid out $2.8 billion of this income to S&Ls in the form of cash and dividends. Nor have the presidents of the Banks been bashful in voting themselves hefty salaries. In 1988 the average salary of Federal Home Loan Bank presidents was $198,175, compared to an average salary of $157,217 for Federal Reserve Bank presidents.

c. Strengthening the mandate of the Federal Home Loan Banks to serve housing credit and community development needs

The statutory mandate of the Federal Home Loan Banks should be reformed to resurrect the Banks' mission as public instrumentalities and to better focus their credit activities on today's most pressing credit needs -- credit for low and moderate income housing, credit for neighborhood revitalization, and capital for community development corporations. In view of the "securitization" of mortgages, which has linked the mortgage market directly to the capital market, there is no general shortage in the supply of funds for standardized mortgages. However, the many non-standardized credits that are the lifeblood of housing rehabilitation and community development cannot readily be converted into securities. As more and more lending institutions limit their lending activities to loans that can be sold in the secondary market or securitized, the supply of funds for "non-standardized" credits is threatened.

Legislation that bails-out FSLIC should include the following amendments to the Federal Home Loan Bank Act.

1. The Department of Housing and Community Development (HUD) should appoint all directors of the 12 Federal Home Loan Banks. In selecting Bank directors HUD should place special emphasis on persons and representatives of organizations engaged in low and moderate income housing, neighborhood revitalization, and local community development activities.

2. At least 30% of the total volume of cash advances outstanding at each Federal Home Loan Bank should be community development cash advances. A community development cash advance would be extended to an S&L (or other institution) pursuant to a plan submitted by the S&L indicating that the funds would be used for a community development purpose. A community development purpose could encompass a broad range of lending activities related to low and moderate income housing, neighborhood revitalization, and small business development. Cash advances, which can be provided on a longer-term, stable-rate basis, represent an excellent source of funds for community development lending.

In 1978 FHLBB Chairman Robert Mckinney with the support of President Carter authorized a $10 billion Community Investment Fund (CIF) program under the cash advance system. During the five-year period from June 1978 through June 1983 the cumulative volume of cash advances extended under the CIF program was $7.9 billion. However, under the Reagan Administration the FHLBB lost interest in the CIF program and delegated full authority to the individual Federal Home Loan Banks to abandon or continue the program as suited their interests. Consequently, the program now operates on a vastly reduced scale. For example, during the three year period from 1986 through 1988 the cumulative volume of CIF cash advances was only $720 million.

3. All federally insured depository institutions should be permitted to borrow cash advances from the Federal Home Loan Banks. If a primary purpose of the cash advance system is to support community development lending, then it is important that commercial banks and credit unions have access to the cash advance facility. In particular, commercial banks have far more resources to bring to community development activities than a seriously depleted S&L industry.

4. The Federal Home Loan Banks should invest 20% of their capital in community development corporations (CDCs) and other non-profit entities that focus on low and moderate income housing and neighborhood revitalization efforts. CDCs provide a critical infrastructure for local community development activities, especially housing rehabilitation, and facilitate neighborhood lending by financial institutions. A recent study commissioned by the Ford Foundation entitled Corrective Capitalism (1987) has found that:

> In a decade of contracting federal domestic activity, CDCs along with their allies in churches and other nonprofit organizations, have become the principal suppliers of low-income housing in the United States. ... CDCs in their quiet way, have become a major component of corrective capitalism; in this free-enterprise nation they are finding ways to open doors to classes and individuals otherwise excluded from the American dream.

Yet, lack of capital has severely constrained the growth and role played by CDCs and other non-profit community development entities. As the Ford Foundation's Corrective Capitalism has observed:

> ...the surface has barely been scratched - in neighborhoods covered, in investments made, in financial and corporate assistance mobilized, in public recognition of the central role community development could play in bringing the opportunities of the American economic system to peoples and neighborhoods long excluded.

VI. Full, Fair, and Efficient Funding of the FSLIC Bailout

a. On-budget financing

The approximately $100 billion needed to meet FSLIC's liabilities should be raised by issuing long-term bonds that are the direct obligations of the U.S. Treasury. Resort to off-budget bond financing -- such as the $10.8 billion of Financing Corporation (FICO) bonds authorized by the FSLIC Recapitalization Act of 1987 -- raises the interest cost on the bond issue. For example, the yield on the $700 million of 30-year FICO bonds issued in December 1988 was 9.64% -- 70 basis points above the rate on comparable direct Treasury bonds. Such a premium for off-budget financing, applied to a 30-year $100 billion bond issue, would raise the total financing cost by $21 billion. It would be irresponsible for the President and Congress in the name of budget gimmickry to impose such a needless cost on those who must ultimately foot the bill for the FSLIC bailout, whether they be individual taxpayers, corporate taxpayers, financial institutions, or consumers.

b. Renegotiate FSLIC's recent assistance agreements

The assistance agreements that FSLIC reached in 1988 must be renegotiated in order to reduce the ultimate cost of the FSLIC bailout. During 1988 FSLIC resolved 217 insolvent savings and loans by issuing $38 billion in liabilities to acquiring firms: approximately $20 billion in 7 to 10 year FSLIC notes and an estimated $18 billion of asset yield maintenance and asset value guarantees. The $20 billion in FSLIC notes issued to S&L acquirors represents a high cost source of bailout funding. The interest that FSLIC pays on these notes is tax exempt and thus they are a hidden drain on Treasury tax revenues. Notwithstanding their tax-exempt status, these notes bear interest rates that are quite high -- often set at the cost of funds for Texas S&Ls plus a mark-up, such as 50 basis points. Long-term Treasury bonds should be issued and substituted for these FSLIC notes. President Bush in proposing to issue $50 billion in long term bonds overlooked the need to refinance the $20 billion in outstanding FSLIC notes. Substitution of lower cost Treasury bonds for the high cost FSLIC notes will require renegotiation of the agreements.

Moreover, the President did not indicate a reliable source of funding for FSLIC's anticipated cost of $18 billion on yield maintenance and asset guarantee commitments.

The FSLIC assistance agreements often fail to provide adequate incentives for the prudent management of the acquired institutions. Many acquirors have invested little of their own cash or equity in the acquired institutions. In many cases the cash injected by the acquiror is less than 1% of the institution's total deposit liabilities, so the acquiror has the same incentive to gamble with the institution as have managements of near-insolvent institutions.

In negotiating these agreements, FSLIC often granted the acquirors exemptions from important safety and soundness rules, such as capital requirements, accounting requirements, and limits on speculative investments. Probably, the most notorious of these safety and soundness waivers is the provision allowing Robert Bass to invest $1 billion of the deposits of American Savings Bank of Stockton, California in investment banking activities, such as financing corporate take-overs and leveraged buy-outs.

Moreover, a number of the agreements appear to authorize the acquiror to assign certain insured deposits to a phantom bank -- known as an "air bank" in the parlance of S&L lawyers -- in the event that FSLIC defaults on any FSLIC notes held by the acquiror. These provisions seem to be designed to allow the acquirors to dump insured depositors out on the street in retaliation against a FSLIC note default.

Some observers contend that the contract clause of the Constitution prevents renegotiation of these high cost, unsound assistance agreements. Yet, careful review of this issue suggests that Congress could enact FSLIC bailout legislation containing renegotiation requirements that would pass constitutional muster. First, it is questionable whether FSLIC had authority to negotiate assistance agreements that resulted in the issuance of $38 billion in FSLIC liabilities to acquirors. The FSLIC Recapitalization Act of 1987 placed a cap of $10.8 on the issuance of FICO bonds, and it is clear that Congress intended that FSLIC return to Congress for additional resources rather than issuing $38 billion in unfunded liabilities. Second, provisions allowing acquirors to shift insured deposits to phantom banks are a breach of FSLIC's fiduciary duty to protect insured depositors. Third, and most important, Congress retains broad authority to set the terms and conditions of access to federal deposit insurance, and this includes the power to modify the terms of any agreement involving a federally insured depository institution. These agreement are not isolated contracts, but undertakings within a constantly evolving scheme of deposit insurance regulation.

c. Using deposit insurance premiums to fund the bailout cost

Most of the cost of the FSLIC bailout will be borne by those who have to pay the interest on the $100 billion of bailout debt. Given current rates on Treasury bonds, the annual interest cost of a $100 billion FSLIC bailout will be approximately $9 billion per year or a 30 year total interest cost of $270 billion. Given the huge size of this annual interest requirement, it is essential that a new revenue stream be established to fund it. If this is not done, then the cost will exacerbate the federal deficit and squeeze out vitally needed expenditures, such as those for low income housing and education.

It is not realistic to look to the savings and loan industry to fund a large share of the interest payment on the FSLIC bailout debt. Savings and loans, by themselves, clearly lack the resources needed to bear this cost. Moreover, imposing even a large share of the cost on S&Ls would be counterproductive, since it would place them at a major competitive disadvantage and drive more toward insolvency. For the same reason, the deposit insurance premium rate for S&Ls and commercial banks should be equalized. In the long run, it is likely to cost taxpayers even more money if the premium rate structure forces S&Ls to operate at a competitive disadvantage vis-a-vis commercial banks.

Allocating the entire bailout cost collectively to both commercial banks and S&Ls would require a large increase in federal deposit insurance premiums. The premium rate would have to jump to about 40 cents per $100 from its current level of 8 cents per $100 at FDIC and 21 cents per $100 at FSLIC. Banking institutions would tend to pass a major cost increase of this nature along to depositors and borrowers who have the least bargaining power -- small depositors who cannot shift their deposits into money market mutual funds and small businesses that are dependent on local banks for loans. The upshot would in all likelihood be a major new round of fee and service charge hikes on small balance deposit accounts, higher rates on small business loans, and a spate of branch closings in inner city neighborhoods. Thus, without some safeguard mechanism, any major increase in deposit insurance premiums would tend to be passed on in this fashion to the less affluent segments of society.

The only way that deposit insurance premiums can be used to fund a major share of the FSLIC bailout without having the cost shifted to bank customers in an extremely regressive manner is to accompany the premium increase with safeguards to protect the less affluent bank customers. The necessary safeguards are lifeline banking requirements, strengthening the Community Reinvestment Act, and branch closing limitations. In fact, such legislation was passed by the House Banking Committee in 1988 -- so, there is already good reason for Congress to enact such measures. However, reliance on deposit insurance premiums as a major source for FSLIC bailout funding will elevate the need for such safeguards to a critical level.

Moreover, if an increase in deposit insurance premiums is going to be used to cover a substantial share of the FSLIC bailout cost, then a comparable assessment should be imposed on money market mutual funds. These funds, which currently total about $300 billion, provide a close substitute for transaction and savings balances at depository institutions. A major increase in deposit insurance premiums coupled with rules to prevent cost-shifting to less affluent bank customers would give banking institutions few options other than to lower interest rates paid on all deposits. This would tend to encourage disintermediation -- the shifting of consumer funds from bank deposits to money market mutual funds. Since money market mutual funds invest only in high quality money market instruments and have no capacity to engage in local community and small business lending, it is unwise to unleash incentives for disintermediation. Thus, an assessment should be imposed on money market mutual funds to neutralize the disintermediation effect of any major increase in deposit insurance premiums.

Moreover, such as assessment is appropriate as a matter of equity, since money market mutual funds are in essence free-riders on the banking system. Money market mutual funds are able to offer transaction account services because they maintain clearing balances with banking institutions; yet, the cost of operating the banking system -- which performs the underlying deposit and payment functions -- is assessed to banking institutions, not money market mutual funds.

d. Realistic and fair options for funding the FSLIC bailout

Four options for creating a new federal revenue stream of approximately $10 billion per year that can be earmarked for the FSLIC bailout are presented below. A long-term revenue stream of this magnitude is needed to service the annual interest payments on the $100 billion FSLIC bailout debt. Should the FSLIC deficit turn out to be $200 billion instead of $100 billion, then combining two options would generate the necessary annual revenue stream of $20 billion per year.

Funds to repay the $100 billion principal of the bailout debt upon maturity can be generated by having the federal deposit insurance funds purchase $10 to $15 billion of long-term, zero-coupon Treasury securities during the early years of the bailout process.

1. Increase the marginal individual federal income tax rate from 28% to 33% for persons in the highest income tax bracket

The existing marginal rate structure of the federal individual income tax law is grossly inequitable. Persons in the next to highest income tax bracket pay a marginal rate of 33%, while persons in the highest income tax bracket -- about the top 1% of income recipients -- pay a marginal rate of only 28%. This change in the tax code would subject persons in the highest income bracket to the same marginal rate as persons in the next to highest income tax bracket. This would be a correction of a wholly insupportable drafting "accident" in the 1986 tax law. This change, which is warranted on equity grounds alone, would generate approximately $10 billion in new tax revenues per year.

2. A one-half percent transaction tax on the sales of equity securities

In 1987 the aggregate dollar volume of registered stock transfers in the U.S. was $2.284 trillion. A one-half percent tax on stock sales could be expected to generate approximately $10 billion in new annual federal revenues. Moreover, it would tend to dampen stock speculation and encourage longer-term investment strategies, a goal endorsed by the Bush Administration.

3. Increased deposit insurance premiums and new excise taxes on mutual funds, junk bonds, LBO financings, and mortgages on luxury homes

This combination of financial assets and liabilities provides a sufficient tax base to generate $10 billion per year in new federal revenues. Additionally, an excise tax should be imposed on investment banking fees associated with hostile take-overs and LBOs. The recent RJR Nabisco buy-out resulted in almost $1 billion in fees.

4. A 10% surtax on the corporate income tax

Revenues from the federal corporate income tax are estimated to be $107 billion for FY 1989. Thus, a 10% surtax would generate approximately $10 billion in new revenues.

Conclusion

In conclusion, it does not follow that the Bush government has to place the burden of the FSLIC bailout on the backs of those taxpayers who are the least able to pay or who labor productively far removed from the gyrations of the financial sector. Instead, the burden for this massive financial debacle should fall primarily on those entities and taxpayers most able to pay or engaged in financial activities providing only limited or arguable productive benefit to society.

This bailout should also provide the occasion for regulatory and structural reform that provides both public and organized consumer checks against future repetitions of this speculative and sordid situation from early alerts to later accountability. Finally, these reforms can redirect depositors funds into more housing credits to enhance the homeownership that S&Ls were suppose to be facilitating.

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PENDING REPORT ON RESTRUCTURING THE FEDERAL HOME LOAN BANKS TO BETTER SERVE LOW AND MODERATE INCOME HOUSING AND NEIGHBORHOOD CREDIT NEEDS

President Bush has acknowledged that the Federal Savings and Loan Insurance Corporation (FSLIC) faces a deficit of $100 billion and must be rescued by a federal bailout of unprecedented magnitude. The President has also called for a major overhaul of the Federal Home Loan Bank System, the complex federal agency structure that has regulated savings and loans. For persons and organizations concerned with credit availability in urban neighborhoods and for low and moderate income housing, the most vital issue raised by the prospect of restructuring the Federal Home Loan Bank System is the fate of the 12 Federal Home Loan Banks -- the powerful, publicly chartered, housing finance institutions that comprise the core of the Federal Home Loan Bank System.

BankWatch has just released a study, Report to U.S. Taxpayers on the Savings and Loan Crisis, that analyzes the causes of the S&L debacle and proposes a set reforms that should accompany the FSLIC bailout. A key recommendation of this study is that the Federal Home Loan Banks should be restructured so that their substantial resources are deployed in ways that stimulate capital and credit for low and moderate income housing and neighborhood reinvestment.

While the Federal Home Loan Banks have received scant public scrutiny over the years, they are nonetheless public instrumentalities with large resources. Collectively, they have a $14 billion capital base; $130 billion in debt securities outstanding; $145 billion in cash advances (loans) outstanding to S&Ls: and in 1987 they had a robust net income of $1.3 billion.

Congress chartered the Federal Home Loan Banks in 1932 for the purpose of supporting the mortgage market by lending cash advances to S&Ls, who would then relend the funds as mortgage loans. However, a 1988 GAO study has found that the Banks' massive borrowing and lending operations do not support housing credit needs in any significant way, but rather serve primarily as a cash generating machine for aggressive S&Ls.

BankWatch is preparing a policy report on restructuring the Federal Home Loan Banks. The report would examine in depth the different ways in which the operations of the Banks could be revamped in order to affirmatively support lending for low and moderate income housing and community development.

A major focus of the report will be to develop a specific proposal for using the $145 billion cash advance window as an incentive system to encourage all federally insured depository institutions --commercial banks and credit unions, as well as S&Ls -- to become more active in community development lending. During the Carter Administration the Federal Home Loan Bank Board -- the federal agency that oversees the 12 Federal Home Loan Banks -- implemented a special cash advance program, know as the Community Investment Fund, under which cash advances were extended at preferential interest rates to S&Ls that had developed a specific plan for community development lending. Considerable activity took place under the Community Investment Fund (CIF) Program with $ 7.9 billion in CIF cash advances extended between 1978 and 1983. However, the Reagan Administration did not support the CIF Program and today it survives on a greatly reduced, caretaker basis.

The report will examine the key issues that need to be resolved if an large-scale cash advance program for community development lending is to be proposed. An important issue is determining the best type of incentive to encourage depository institutions to participate in the program. For example, under the Carter Administration, CIF Program cash advances were extended to S&Ls at an interest rate one-half percent below the regular cash advance rate. Another approach would be to require that a minimum percentage of an institution's total cash advances must be community development cash advances.

A second vital issue is the need for rigorous criteria to define the type of community development lending program that would qualify an institution for access to preferential community development cash advances. If the qualification criteria are not rigorous, then the program in all likelihood would not stimulate new community development lending. In this situation, institutions would be receiving preferential cash advances and public accolades for lending activities that they would undertake even without the program.

Another key issue is the best approach for extending access to the cash advance facility -- which currently is limited to S&Ls and savings banks -- to commercial banks and credit unions. Participation by commercial banks is particularly important because commercial banks in toto have financial resources that are two and one-half times greater than those of the declining S&L industry.

A second strategy for mobilizing Federal Home Loan Bank resources for community development purposes would be to require the Banks to invest a portion, say 20%, of their capital in community development corporations and various non-profit entities that serve low and moderate income housing. A major issue that needs careful consideration is determining the type of "capital" investments that one could realistically expect the Banks to make and that would at the same time be useful to CDCs and non-profit housing development entities.

A third strategy would be to establish within the Federal Home Loan Banks a pool of funds that could be used to provide mortgage loans for low income housing at deeply subsidized low interest rates. The pool of subsidized funds would have to be generated by a source outside the Banks, such as an assets tax on all financial institutions or direct federal appropriation. However, it might be very useful to lodge administration of the subsidized funds in the Banks, since they could, in turn, channel the funds through depository institutions to ultimate borrowers and monitor the results.

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SUMMARY OF THE NADER REPORT ON THE S&L CRISIS

The Ralph Nader study, Report To U.S. Taxpayers On The Savings & Loan Crisis, February 1989, presents a comprehensive plan to address the savings and loan crisis. Key recommendations of the Nader report are as follows:

** A set of reforms to deter unsound banking practices and fraud in future years -- tough new standards for civil and criminal liability on the part of bank officers for negligence, fraud, and self-dealing; prohibition of investments in real estate equity; deposit growth ceilings for weak institutions.

** A federal policy that does not force S&Ls to invest a high percentage of their assets in mortgage loans

** Equalization of deposit insurance premiums paid by S&Ls and commercial banks.

** A new mandate for the 12 Federal Home Loan Banks to use their resources to support neighborhood revitalization and local community development -- 30% of cash advances earmarked for community development purposes; commercial bank and credit union access to the cash advance facility; and divorce of the 12 Banks from S&L supervision.

** Four options for raising $10 billion per year to help cover the cost of the FSLIC bailout -- without new federal revenues of this magnitude two-thirds or more of the bailout cost will be borne by individual taxpayers at large.

I. Safety and Soundness Reform

Restrict investment powers. Investment in real estate equity, which is risky in and of itself and also undermines objectivity in credit judgments, has been a principal cause of S&L failure. A 1987 FHLBB study of the condition of 33 California S&Ls that had made extensive real estate equity investments in the early 1980's found that by 1986 5 of these institutions had failed, 1 had merged, and the remaining 27 had an average net worth of 0.3% and an average return on assets of negative 3.3%.

A number of states, including Texas and California, have granted state chartered S&Ls broad authority to invest in real estate equity and other kinds of direct investments. The imprudence of this policy is manifest in the massive losses that state chartered S&Ls have imposed on FSLIC. In October 1988 the FHLBB calculated that state chartered S&Ls, which represent only 36% of the total assets of all

FSLIC insured institutions, are responsible for 81% of FSLIC's current losses.

Federally insured S&Ls, both state chartered and federally chartered, should be prohibited from making real estate equity or other direct investments. Also, S&L holding companies should not exercise real estate equity investment powers broader than those available to bank holding companies.

Officer and director liability for misconduct. A recent GAO review of 26 S&L failures and 184 commercial bank failures found in virtually every case "a breach of [management's] fiduciary duty to operate a financial institution in a safe and sound manner." In particular, GAO found management fraud or insider abuse in 100% of S&L failures and 64& of commercial bank failures.

Greater officer and director liability for misconduct in operating federally insured deposit institutions is vitally needed in order to instill greater fiduciary discipline in bank managements. Uninsured depositors and individual shareholders should be given standing to bring direct suits (as opposed to derivative suits) against officers and directors for bank misconduct that leads to failure. A cause of action for bank misconduct should arise whenever fraud, negligence, or self-dealing have contributed to the failure of a federally insured institution. Once a civil or criminal suit for bank misconduct has been filed, the court should have clear authority to issue a pre-trial freeze order to prevent the dissipation of assets by the defendants. Both private plaintiffs and the government should be authorized to recover treble damages in bank misconduct suits.

II. Future Role of S&Ls

Requiring or encouraging S&Ls to hold a high percentage of their assets in residential mortgage loans should no longer be a goal of federal financial regulatory policy. Concentration of residential mortgage loans in the portfolios of S&Ls creates an inherently unstable situation. If the mortgage loans are fixed rate, then S&Ls are playing interest rate roulette and whenever interest rates escalate the deposit insurance funds and ultimately taxpayers will have to cover their losses. On the other hand, if the mortgage loans are adjustable rate mortgages (ARMs), then they become interest rate time bombs in the hands of individual home owners.

Adjustable rate mortgages. In fact, many S&Ls with a portfolio concentration in residential mortgages have become very aggressive in shifting interest rate risk to home owners in the form of ARMs that allow rapid rate increases. S&Ls using "teaser" rates and other hard sell tactics have pushed so many ARMs on home buyers in recent years that by year-end 1987 54% of the 1-4 family mortgage loans held by FSLIC insured institutions were ARMs. Home owners with ARMs will get a taste of interest rate shock this spring and summer when the interest rate on their ARMs is scheduled for a sharp upward jump. On a typical ARM -- whose rate is often tied to the interest rate on 1 year Treasury securities -- the interest rate is likely to jump 2 full percentage points from 9 3/8 % to 11 3/8%. While ARMs may be useful for affluent and upwardly mobile home buyers, they are not a suitable mortgage instrument for persons with moderate incomes or limited upward mobility.

Overall supply of mortgage credit. The restructuring of the mortgage market during the last 15 years has greatly expanded the number of mortgage originators and mortgage investors. For example, during 1987 54.8% of the 1-4 family mortgage loan originations were converted into mortgage-related securities, many of which were purchased by pension funds, insurance companies, and other capital market investors that seek long-term fixed rate investments. Thus, even though the share of the nation's stock of residential mortgage loans held by S&Ls has declined from 44.6% in 1977 to 26.9% in 1987, there has been no shortage in the overall supply of mortgage credit.

Moreover, the new risk-based capital rules recently adopted by the Federal Reserve Board, Comptroller of the Currency, and the FDIC will provide an incentive for commercial banks to increase their holdings of mortgage loans and mortgage-related securities. Under these rules the risk-adjusted capital requirement for residential mortgage loans is only 4%, compared to a capital requirement of 8% for commercial loans.

Many S&Ls will undoubtedly continue to specialize in mortgage lending, especially the origination of 1-4 family mortgage loans; but, the restructuring of the mortgage market eliminates the need to require S&Ls to hold a large share of their assets in residential mortgages in order to assure an adequate supply of mortgage credit; while the spectre of interest rate risk now renders such forced specialization unsafe and unsound for both the deposit insurance funds and individual home owners. Consequently, S&Ls should be allowed to diversify within the boundaries of traditional commercial bank lending authority. The inevitable conclusion is that there is no public purpose in maintaining separate charters for commercial banks and S&Ls.

Equal deposit insurance premiums for S&Ls and commercial banks. S&Ls presently pay deposit insurance premiums to FSLIC at a rate that is more than two and one-half times greater than the premium rate that FDIC charges commercial banks. If S&Ls are required to pay a substantially higher premium rate than commercial banks for an extended period of time, this will force them to operate at a significant competitive advantage, weaken their ability to rebuild their capital base, and ultimately drive more toward insolvency. Such a policy would be shortsighted and counterproductive. It might earn FSLIC additional revenues up front, but in the long-run FSLIC's costs would be higher and taxpayers are likely to have to pay more. Clearly, the appropriate policy is to equalize deposit insurance premiums for S&Ls and commercial banks.

Equalization of deposit insurance premiums implies that commercial banks may be required to contribute to the FSLIC bailout -- unless S&L and commercial bank premiums are both set so low that there is no effective contribution from either source. The notion of commercial bank contribution, although evoking shrill protests from the commercial banking lobby, is not inequitable. Federal deposit insurance, like other forms of insurance, is a risk pooling system under which healthy members pay to cover the costs of sick members. Under the circumstances, it is reasonable for Congress to view both FSLIC and FDIC insured institutions as comprising the underlying risk pool and to adopt a premium equalization strategy.

III. Reform of the Federal Home Loan Banks

Pressing credit needs. While the overall supply of mortgage credit is adequate, there are many specific unmet or underserved credit needs. These run the gamut from credit for low and moderate income housing, housing rehab loans, credit and capital for non-profit housing developers and local community development entities, to intermediate term credit for small business. These gaps in credit availability are caused by various factors: patterns of disinvestment in older urban neighborhoods; racial discrimination; standardization of mortgage loans; and lender reluctance to extend fixed-rate financing. In particular, many depository institutions are limiting their lending activities to loans that can be resold in the secondary market or securitized. Yet, the non-standardized credits that are the lifeblood of housing rehabilitation and community development cannot be sold into secondary markets or securitized. Moreover, in the case of credit and capital for low income housing, substantial subsidies are needed to surmount the affordability barrier.

The Federal Home Loan Banks: public instrumentalities diverted to private use. The Federal Home Loan Bank Act of 1932 authorized the establishment of the 12 Federal Home Loan Banks as "instrumentalities of the federal government." The purpose of the Banks was to stabilize and enhance the flow of residential mortgage credit by raising funds in the capital market and lending "cash advances" to S&Ls. The Banks have prospered and today their financial resources are enormous. On a consolidated basis, the 12 Banks have a $14 billion capital base; $130 billion in debt securities outstanding; $145 billion in cash advances (loans) outstanding to S&Ls; and in 1987 they had a robust net income of $1.3 billion.

However, as presently operated the cash advance system is not supporting the mortgage market in a manner that provides discernible public benefit, but rather is being used by S&Ls to balloon their balance sheets. The FHLBB and the Federal Home Loan Banks allow S&Ls to use cash advances to fund any kind of lending or investment activity. In fact, a 1988 GAO study of the cash advance system could not identify any way in which this massive funding mechanism was

serving housing credit needs. Moreover, the cash advance function envisioned by Congress in 1932 -- providing S&Ls with access to the capital market and liquidity -- has in large measure been rendered obsolete by the growing ability of S&Ls to access the capital market directly through mortgage securitization and to use the secondary market as a source of liquidity.

A new mandate for the Federal Home Loan Banks to focus on unmet and underserved credit needs. The statutory mandate of the Federal Home Loan Banks should be reformed to resurrect the Banks as public instrumentalities and to focus their credit activities on today's most pressing credit needs. To accomplish this goal the Federal Home Loan Bank Act should be amended as follows.

1. The Department of Housing and Community Development (HUD) should appoint all directors of the 12 Federal Home Loan Banks. In selecting Bank directors, HUD should place special emphasis on persons and representatives of organizations engaged in low and moderate income housing, neighborhood revitalization, and local community development activities.

2. At least 30% of the total volume of cash advances outstanding at each Federal Home Loan Bank should be community development cash advances. A community development cash advance would be extended to an S&L (or other institution) pursuant to a plan submitted by the S&L indicating that the funds would be used for a community development purpose. A community development purpose could encompass a broad range of lending activities related to low and moderate income housing, neighborhood revitalization, and small business development.

3. All federally insured depository institutions should be permitted to borrow cash advances from the Federal Home Loan Banks (i.e., commercial banks and credit unions, as well as S&Ls).

4. The Federal Home Loan Banks should invest 20% of their capital in community development corporations (CDCs) and other non-profit entities that focus on low and moderate income housing and neighborhood revitalization efforts.

There is strong precedent for a major community development cash advance program, the centerpiece in the proposed resurrection of the Federal Home Loan Banks. At the urging of President Carter, the 12 Federal Home Loan Banks in 1978 implemented a special cash advance program, known as the Community Investment Fund (CIF). Under the CIF Program cash advances were extended at preferential interest rates to S&Ls that had developed a specific plan for community development lending. From 1978 to 1983 $7.9 billion in cash advances were extended under the CIF Program. However, under the Reagan Administration the FHLBB, which oversees the 12 Federal Home Loan Banks, lost interest in the CIF Program and today it survives on a greatly reduced, caretaker basis.

Divorcing the Federal Home Loan Banks from S&L supervision. The 12 Federal Home Loan Banks play a major role in the safety and soundness supervision of S&Ls. Given that S&Ls elect a clear majority of the directors of the Banks, assigning supervisory functions to the Banks creates a severe conflict of interest and has been a major factor in the lax supervision of S&Ls.

Further, resurrection of the Federal Home Loan Banks under a new credit needs mandate will provide further reason for divorcing the Banks from supervisory functions. As the S&L debacle has painfully demonstrated, the promotion of housing credit does not mix well with safety and soundness supervision. supervision do not mix well.

IV. Funding the FSLIC Bailout Cost

Over the next few years the federal government will need to raise at minimum $100 billion in cash to fund the FSLIC bailout -- $50 billion in new funds under the Bush plan, $38 billion to refinance FSLIC's high cost outstanding liabilities, and a $10 billion FSLIC contingency fund for additional S&L failures. At current interest rates, just servicing the interest cost on the $100 billion bailout debt will require a federal payment of $9 billion per year. Moreover, above and beyond the interest cost is the need for additional revenue streams to recapitalize FSLIC, strengthen FDIC, and pay the principal on the $100 billion bailout debt at maturity.

Even under the heroic assumption that a combination of deposit insurance premiums, recovery from S&L asset liquidations, and other FSLIC revenues will be sufficient to fully recapitalize the insurance funds and pay off the $100 billion bailout debt at maturity, the $9 billion annual interest payment will inevitably be a charge against federal revenues. If a new federal revenue stream of at least $9 billion per year is not created by Congress, then this annual interest charge will exacerbate the federal deficit and force more cutbacks in social spending or increased taxes born by taxpayers at large.

The correct approach to funding the FSLIC bailout is to impose the cost of generating new federal revenues on individuals or sectors that have benefited from inequities in the tax code or are engaged in speculative financial activities that should be dampened. Four reasonable options are presented below for raising the federal revenues needed to fund the annual interest cost on the bailout debt in an equitable and productive manner. Each of these options would raise approximately $10 billion per year in new federal revenues.

a. An increase in the marginal federal individual income tax rate from 28% to 33% for persons in the highest income tax bracket.

b. A one-half percent transaction tax on the sale of equity securities.

c. Higher deposit insurance premiums and new excise taxes on mutual funds, junk bonds, LBO financings, and mortgages on luxury homes.

d. A 10% surtax on the corporate income tax.

NATIONAL TAXPAYERS UNION

A NONPARTISAN, NONPROFIT ORGANIZATION DEDICATED TO THE PUBLIC INTEREST

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Statement of David L. Keating
Executive Vice President
National Taxpayers Union

submitted to

the Senate Banking Committee
March 15, 1989

on

the Administration's Plan to Resolve
the Savings & Loan Crisis

On behalf of the 150,000 members of the National Taxpayers Union we are pleased to submit this statement to the Committee. However, as the nation's largest taxpayer organization, representing members who are interested in reducing and limiting government taxes and spending, we are not at all pleased at the Federal government's handling of the Federal deposit insurance system or the bills American taxpayers now must pay.

While the proposal submitted by President Bush makes several steps in the direction of much-needed reforms, it should be strengthened by this Committee and by the Congress, not weakened.

The Committee should not weaken or delay the Administration's proposal to increase the capitalization requirements for savings and loan institutions. It's especially important that the capital requirement enforcement mechanism be strengthened.

Under the President's proposal, thrift equity capital generally must equal 6% of assets by June 1, 1991 and 8% before the end of 1992. Thrifts that do not comply with these capital requirements would be prohibited from making new loans.

Higher capitalization requirements are the keystone of the Bush reform plan. If Congress weakens or delays these proposals, taxpayers will pay for larger bailouts in the coming years.

Many thrifts complain that they could not meet this capital requirement. Tough. Taxpayers already owe $100 billion and guarantee $2.7 trillion of deposits. Is it really too much to ask that thrifts have more of their own money at risk?

The FSLIC bailout will cost approximately $100 billion, although precise estimates are impossible. This is an enormous sum of money, exceeding the cost of the Marshall Plan, the Lockheed bailout, the New York City bailout and the Chrysler bailout combined! Even under generous assumptions, those programs only cost $84 billion in 1988 dollars. $100 billion represents $1,600 for each family of four in America.

We can't afford another huge bank or thrift bailout in the future. The most important reason for the current fiscal disaster is that the current system of deposit insurance fails to provide adequate incentives for prudent risk taking. It's easy to risk other people's money. Our money — the taxpayers' money — has been put at risk by managers at many banks and thrifts who have literally nothing to lose from taking enormous risks at our expense.

That's why it's critical that higher capitalization standards be enacted and enforced. Unless banks and thrifts have their own money at risk, the taxpayers' money will continue to be at risk in the future.

The Shadow Financial Regulatory Committee, a group of economists who have studied this problem, also supports higher capital standards for banks and thrifts. They say that "Fundamental reform is necessary and requires that the current regulatory and supervisory system be restructured to correct risk-taking incentive problems and structural defects in the deposit insurance system . . . This proposal embodies:

* Capital adequacy policies
* Increased monitoring of asset values
* Timely reorganization before a depository institution's economic capital is exhausted
* Enchanced market incentives and rigorous supervisory enforcement."

The Shadow Committee thinks adequate capital would equal at least 10% of assets. They propose requiring three different levels of supervision if capital falls below this level, with each supervisory step becoming more severe until mandatory recapitalization and reorganization is required when capital sinks below 3% of assets.

If capital falls below 10% of assets, the Federal supervisors would have the authority to require submission of a plan to raise capital to reach the 10% level, suspend dividend or other payments and restrict asset growth.

If capital falls below 6% of assets, asset growth would be prohibited and "suspension of dividends, interest payments on subordinated debt and unapproved outflows of funds . . . would be mandated."

President Bush's plan does not do enough to enforce his proposed capital requirements. For example, he proposes that regulators would have the authority to close down thinly capitalized thrifts. That's not enough. Regulators should be required to take action to stop asset growth and suspend payments to investors.

Robert Litan, Senior Fellow and Director, Center for Economic

Progress and Employment at the Brookings Institution, says an "'early intervention' mechanism should be mandatory so that regulators have the statutory responsibility — insulated from political pressure — to step into institutions before they fall into insolvency."

Dr. Litan makes another very important point — Congress should act quickly to give regulators this duty. "They will need it to keep many weakly capitalized thrifts that have little hope of meeting the tighter capital standards by 1991 in a conventional fashion . . . from taking 'bet the bank' risks."

Even more needs to be done. Imagine that you own or run a thrift and know that you cannot raise the required capital through conventional methods before the deadline. What would you do? Chances are you might be tempted to take enormous risks, hoping that enough investments will pay off big and that the capital standards could be met before the deadline.

Therefore, we strongly recommend that asset growth at thrifts that do not meet the current 6% capital ratio, be immediately prohibited from growing until the capital requirements have been exceeded. Without a prohibition on increased asset growth by weakly capitalized thrifts, many of these thinly capitalized institutions will go out and offer higher rates of interest for deposits, take that money and take larger risks in a "bet the bank" strategy of meeting the capital requirements by 1991. The Committee should use a tactic often used by the tax-writing committees and prohibit assets at undercapitalized thrifts from exceeding those reached as of the date mark-up on the legislation begins.

In order to ensure that the capital standards are meaningful, it is very important that we move toward mandating market value accounting for banks and thrifts.

When a federally insured bank or thrift fails, taxpayers are liable for the difference between the market value of the assets and liabilities. Historical cost accounting, which is used under Generally Accepted Accounting Principles, can hide huge losses on non-performing loans that have lost much of their value. If capital standards are based on historical costs, bad loans will be hidden and the capital standards may not offer enough protection for taxpayers.

Money needs to be made available more quickly to shut down insolvent thrifts and banks and limit taxpayer exposure in the coming months and years.

The plan should provide more cash more quickly to enable federal regulators to shut down insolvent institutions. These insolvent thrifts and banks are offering higher interest rates on deposits, diverting money from viable institutions and raising their costs, thus

making it more likely that more of them will fail.

Let's face it, insolvent institutions have already loaned the money. Unless the Federal government repudiates its deposit insurance guarantee, this money is gone. The Federal government should prevent more money from being lost in the future by closing down the institutions that are hemmorhaging taxpayers' wallets and pocketbooks.

The best available data indicates that FSLIC losses are rising by fifteen to twenty percent each year. The quicker we act to stop these losses, the more money taxpayers will save. After all, the Federal government can currently borrow money at 9.5 percent and use that money to prevent liabilities from increasing at fifteen to twenty percent. Any time you can borrow at 9.5 percent to save fifteen to twenty percent, you should do it.

Financial institution analyst Bert Ely has recommended that "fifty billion of cash should be spent by Christmas. This would enable regulators to immediately cut the deposit interest rate in every insolvent thrift down to the rates offered by solvent banks and thrifts. These rates would eliminate the unhealthy rate competition that has hurt all banks and thrifts. This rate competition also has funded an unintended wealth transfer from taxpayers to depositors."

Once these interest rates are reduced, cash will flow out of the sick thrifts to higher yielding investments or to banks and thrifts closer to depositors' homes. These banks and thrifts are the ones that have no money of their own at stake. It is inherently dangerous to allow these institutions to continue to invest taxpayer guaranteed deposits. When they have none of their own money at stake, how can they possibly be responsible with federal guarantees? They can't.

It is essential that Congress provide adequate funding for federal supervisors to close down these insolvent institutions within the next two years. If the FDIC and FSLIC can't do it, then the agencies should be given the authority to contract out for assistance or to hire more employees to do the job quickly and properly. It will save money in the long run.

Federal supervisors should receive a reasonable bonus if the work is done efficiently before the deadline.

President Bush's savings and loan rescue plan fails to eliminate the subsidy for risk taking in the deposit insurance system.

One thing that should be clear from the current financial crisis is that the deposit insurance system has caused the problems Congress faces today. There are simply too many problems that can be hidden in too many ways for Federal regulators to keep up. Technological changes have been sweeping through the financial services industry and are causing massive changes that outstrip the ability of a regulatory structure to adapt. Therefore, incentives should be placed into this structure that would automatically cause institution managers and Federal regulators to act responsibly.

Many wealthy, sophisticated investors are depositing through electronic brokerage huge sums of money at insolvent thrifts to take advantage of above market interest rates. Originally, the deposit insurance system protected accounts up to $2,500 and was designed to protect just the small depositor. The deposit insurance limit now stands at $100,000 with a much higher implied limit. In fact, there is no theoretical limit for a depositor who is willing to break his deposits into enough accounts at enough banks.

As a result, discipline from depositors has vanished altogether. We would support many different approaches to providing discipline from depositors, while still protecting the small depositor.

Limiting Deposit Insurance

One effective reform would be to limit the deposit insurance guarantee to $100,000 per citizen. Once an individual depositor has been paid $100,000 from the Federal government, then no more deposit insurance should be available to that individual during a specified time period — say three years. Such a reform would protect the small depositor while discouraging wealthy and sophisticated depositors from simply chasing the highest federally guaranteed rates.

Another interesting alternative has been offered by analyst Fred Smith of the Competitive Enterprise Institute. He would cap the total amount of federal deposit insurance available to the current $2.7 trillion. He would then allocate that sum to insured institutions "based on their present deposit base. This federal insurance would be made tradable. Institutions desiring to grow would either have to purchase federal insurance in the market, or phase in private deposit insurance."

Risk Based Premiums

One way to build these incentives is to price deposit insurance based on the risk taken with the loans. The current deposit insurance system charges one flat rate, whether the institution is conservatively run or taking a high flyer approach to lending. Imagine what would happen if automobile insurance companies charged the same insurance premiums to convicted drunk drivers as to drivers who have not had an accident in ten years. If automobile drivers knew that their insurance rates would never increase, no matter how irresponsibly they drive, we'd see more accidents and more insurance claims.

That's exactly what has happened with Federal deposit insurance. The high risk takers are subsidized at the expense of the conservative institutions, with taxpayers paying for the fiscal wreckage. Charging premiums based on the amount of risk incurred would help equalize the competition, and reduce claims on deposit insurance.

This approach isn't perfect. How can flatfooted regulators possibly determine prices that reflect the actual risk? They can't. Regulators will never properly assess risk premiums because their money is not at stake. Also, because regulations take a long time to be written and regulators are subject to political pressures, they will often fall far behind adjusting premiums for changes in risk. But different premium charges would recoup some of the risk differences in the portfolios. Inefficiencies would remain, but would be far smaller than those caused by a flat rate premium structure.

Private Insurance/Federal Guarantees

We also favor deposit insurance expert Bert Ely's innovative approach for pricing deposit insurance. He would require that all deposits be insured, but not by the Federal government. Although his deposit insurance plan would essentially require private insurance, he would back that insurance up with emergency lending authority from the Federal Reserve. Federal Reserve loans would be fully collateralized against an institution's loans.

Ely's proposal would greatly reduce the financial risk to the Federal government, while preserving the financial stability of the banking system.

Under his proposal, two safety nets would have to break before the government would lose money. First, the private insurance would have to be exhausted. Second, the Federal Reserve's loan collateral would have to be inadequate. Only after both sources of funds — the insurance and the collateral — have been exhausted would the Federal government stand to lose any money.

There are many advantages to privately provided deposit insurance. The premiums would change very quickly because institutions providing the insurance guarantees would have their money at risk. Ely envisions that most of the insurance would take the form of standby letters of credit that "would be priced on a risk-sensitive basis."

The institutions would be closely monitored by the insurers, the ones who have the financial sophistication and a clear incentive to watch an institution's lending practices closely. After all, if its loans go bad, the insurer must make up the difference.

Ely notes that "if a bank increases its riskiness, higher deposit-insurance premiums would hit the bank's bottom line within a month or so. In this manner, insurance premiums would quickly break unrewarding banking practices. Bankers would not engage in high-risk activities such as junk-bond speculation, real-estate development or such exotica as fish farming unless returns from those activities were high enough to offset the higher insurance premiums."

The Congress should not authorize creation of a new off-budget Resolution Funding Corporation. Instead, money raised to close insolvent financial institutions should be funded through normal Treasury bonds.

Whenever the Federal government attempts to borrow money through government sponsored corporations, it pays a higher interest rate. This occurs even if the bonds are backed by the full faith and credit of the United States simply because there's an information cost associated with the different name and a slight increase in the difficulty in buying and selling these bonds. Analyst Bert Ely says that higher interest rates "will cost the taxpayer dearly. For example, $50 billion of 30-year bonds with a coupon 25 basis points higher than comparable Treasury debt will require an additional $125 million annually in interest payments. The present value of that additional interest is $1.3 billion!" Other analysts say the additional costs could reach $2 billion. Certainly, more than $50 billion will be needed to close all insolvent banks and thrifts, with higher interest costs to the taxpayer if this Resolution Funding Corporation is created.

Congress shouldn't make the most expensive bailout in history even more expensive by creating needless off-budget agencies to borrow money. Two billion dollars is an awful lot of money to spend for a worthless accounting gimmick.

These liabilities were incurred in previous years. Mr. Ely has suggested that government financial statements for the 1980s be restated to reflect these liabilities as they were incurred. Others have suggested that the entire $50 billion be put into fiscal year 1989 so as not to affect the Gramm-Rudman targets for forthcoming fiscal years. If the government had followed proper accounting, Mr. Ely's suggestion would have been unnecessary because the liabilities would have appeared on the government's ledgers as they were incurred. Although these proposals have their flaws, they are far preferable to creating a new agency.

The Committee should approve the steps to improve supervision, but should avoid reregulation.

Some commentators have speculated that deregulation caused the huge increases in bank and thrift failures. This is wrong.

Actually, overregulation was a major cause of today's financial problems. The current crisis has its roots in the 1970s when thrifts found themselves with low-rate, long-term mortgages and high-rate, short-term deposits.

With interest rate caps in effect, savings and loan institutions found that savers withdrew their money and began placing it in higher yielding investments. At the same time, the rise in interest rates made the actual value of the mortgages worth less. One study said the thrift industry's net worth was a negative $11 billion in 1971.

About twenty years ago the Federal Home Loan Bank Board recommended several deregulatory actions that would have increased the thrift industry's competitiveness and lessened its vulnerability to interest rate swings. But no action was taken by Congress or the president.

These problems worsened during the 1970s as interest rates reached unprecedented levels. With the development of money market mutual funds, hundreds of billions of dollars flowed to these new funds while thrift industry deposits withered. By the time Congress finally adopted a measure to partially deregulate the thrift industry, the industry's net worth had already plunged to $150 billion of red ink.

Unfortunately, the deregulatory moves of the 1980s were not accompanied by requirements that thinly capitalized thrifts be closed. Today's financial crisis was caused not by deregulation, but by low capital standards. The answer, then, is to ensure that those who invest Federally insured deposits have their money at risk as well. Litan says that "Virtually meaningless capital standards are the central villain in this story (backed by many regulatory and political accomplices), not broader thrift powers."

Regulation is inherently destabilizing because of its rigid nature. With the increasing rate of technological innovations in the financial services industry, adding more regulations to the current structure will make it less likely that banks and thrifts can compete and survive. As it becomes more difficult to compete, some of them will take more credit risks with less qualified creditors and charge higher rates in an attempt to make up for lost opportunities.

Geographic deregulation can promote stability by allowing banks and thrifts to reduce their risk by making loans over a broader geographic area. If one area experiences a sharp economic downturn, such as the problems we have seen in farming or energy producing regions, loans made in other prosperous regions would help the bank or thrift to survive.

We hope the Congress and the Administration will do something to revisit the incredible deals agreed to by the Federal Home Loan Bank Board before the end of 1988.

As detailed in the February 20, 1989 issue of Barron's, Benjamin J. Stein writes that the acquirers who purchased these thrifts "were not buying cadavers. They were buying juicy tax savings that any taxpayer in the world would have loved to have. For purchase prices in the tens of millions, acquirers got tax breaks in the hundreds of millions. It was, so to speak, a steal."

And who will pay the price? The American taxpayer.

The Bank Board not only guaranteed the sick part of the thrift's portfolios, but guaranteed against losses in other parts of loans on the books of these thrifts. As Stein noted, "the deal was mouth-watering. The acquirers made money on tax breaks right off the bat. They had no exposure on the bad loan portfolio. They had very little good asset exposure. And some deals, the minimum rate of return after cost of administration and capital was also guaranteed."

Taxpayers are being asked to pay too much of the bailout cost.

Under the Bush plan, thrift deposit insurance premiums would rise from current 21 cents per $100 to 23 cents in 1991. Beginning in 1994 the premium will decline to 18 cents.

Yet if you look at the yield differential between money market funds that invest in Federal government securities and those that invest in other securities, the difference is typically 25 cents to 30 cents per $100. Charging higher deposit insurance premiums in this 25 to 30 basis points range for both thrifts and banks will reduce the burden on taxpayers, especially if the money is used, as it should be, to reduce other taxes that would have otherwise helped pay for this bailout.

If such charges are higher than what would be generated under private insurance, then this will encourage the industry to design a system where insurance can be provided privately, thus dramatically reducing the contingent liabilities on Federal taxpayers. Congress should encourage the industry to propose a system of private insurance.

In summary, we hope the Committee will move swiftly to provide adequate funds to close down insolvent thrifts and banks. Every month of delay adds another $1 billion to the problem. It's also extremely important that Congress enact and provide for enforcement of adequate capital standards. Finally, more incentives need to be built into the deposit insurance system to assure prudent risk taking. Because these incentives may take a while to develop in legislative form, perhaps they can be addressed in a second piece of legislation to be adopted later this year, or at the latest by early next year.

Unless the Congress reforms the deposit insurance system, we could see a larger financial crisis in the next few years.

DK17:4

PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART IV OF IV

THURSDAY, MARCH 16, 1989

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10:30 a.m. in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dixon, Shelby, Bryan, Heinz, D'Amato, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The Chairman. The committee will come to order.

We have this morning, as is often the case, other committee hearings that are going on simultaneously as well as important action on the Senate floor. We happen to have a session of the Subcommittee on International Finance meeting at this very time downstairs with Mr. Mulford, of the Treasury Department, on the issue of Third World debt. Subcommittee Chairman Sarbanes is conducting that and I've been down participating in that, so we're getting a little bit of a late start.

I want to welcome our witnesses here this morning and I will introduce them just a little bit later.

This is our 17th and next to last hearing we anticipate on the FSLIC savings and loan issue. Throughout these committee hearings I have emphasized the view that I think the powers of federally insured—I underline federally insured—State-chartered thrift institutions should be limited by statute to those activities that are authorized for Federal thrift institutions. Or said another way, if the States want to add something to the charters that the State ought to accept the responsibility for insuring that activity if it's to be insured, but not to expect the Federal Government to do it. That's one of the issues that is before us today and it's before the Congress as we deal with the savings and loan issue. I know we will get into a discussion of that today.

We have also been hearing from others.

Last month the vice chairman of the Federal Reserve Board, Manuel Johnson, wrote me an unsolicited letter applauding that position and he said in that letter:

> Your point that a major part of the problem has been the proliferation of risky actitivities granted by authorities in the States is especially significant. We cannot afford State competition to liberalize the powers of federally insured deposit institutions while the U.S. taxpayer absorbs most of the risk.

Then, last week, the home builders, the mortgage bankers, and the realtors all agreed officially with that position here before this committee. For example, Jerome Blank, chairman of the realtors legislative committee, testified:

> We do not believe that the administration proposal goes far enough. We believe it should limit the activities of State chartered thrifts to those activities permissible for federally chartered institutions. Looking at the current situation makes it quite obvious that institutions involved in nontraditional activities, such as real estate equity investment, have indeed threatened the stability of the entire financial system and have increased taxpayer liability to countless and as yet unknown billions of dollars.

Yesterday, several major consumer groups agreed that federally insured thrift institutions should not be allowed to engage directly in risky activities and should be restricted to federally authorized activities.

Now proponents of the expanded State powers sometimes quote data purporting to show that Federal thrifts fail almost as often as State thrifts. These data are misleading, however. In recent years when FSLIC took over a sick state thrift, it typically converted it to a Federal charter. Any analysis that fails to take this fact into account will greatly exaggerate the Federal S&L's contribution to the problem.

Many of the institutions classified as Federal got into trouble while they had State charters. So it is essential to examine the charter type before the thrift became insolvent.

The Bank Board has provided us with some data and it shows that since 1983 more State chartered failed thrifts have needed assistance than Federal ones. The amount of assistance given to State thrifts, $28.7 billion, over the 6-year period is noticeably higher than that for Federal thrifts, which was a figure of $10.7 billion.

Thrifts in Texas and California, with their extremely liberal powers, have accounted for over ¾ of the assistance given to State thrifts during the past 2 years and over half of all of the assistance given to all thrifts.

Now today the committee will hear from the Conference of State Bank Supervisors and the American Council of State Savings Supervisors. For obvious reasons, I expect that the associations will disagree with the view that I am expressing on these issues. Nevertheless, I welcome their testimony and very much want to hear it and engage in a discussion on it.

I want to say one other thing if I may both to my colleagues and to those here today. That is, as we've taken the time to reconstruct the reasons for this catastrophic systems failure of the savings and loan system, we are doing so to try to understand what went wrong so that we can repair those things so that this kind of a catastrophic failure can't happen again.

At the same time, I think we have to be alert to other ways in which future catastrophic failures could occur that might not follow precisely the same pattern of the one that we are trying to dig out now. That's at least $100 billion, and I think probably substantially more than that.

Our assignment is not to go back and be good detectives and figuring out what blew the holes in the system the last time and to fix those problems, but it is also to consider what else could blow holes in the system in the future that could give us a catastrophic failure of equal consequence but perhaps coming with a different sequence of events. After a $100 billion has been lost, I view the responsibility of this committee in redesigning this system and to redesign it and to reform it in such a way that we not only identify and solve the past areas of greatest vulnerability but we identify any other areas of vulnerability that are out there and inherent in the system design and see that those are fixed at the same time.

I think if this committee has to come back around in a matter of 2 or 3 or 4 years and say, well, we gave it our best shot but we didn't get it right and now this problem is back again and several tens of billions of dollars of additional losses have occurred, that that is not a sufficient outcome of our work at this time and I don't want to see that happen.

So with that, let me now indicate—I'll introduce our witnesses after I've asked my colleagues for their opening comments. Senator D'Amato.

Senator D'AMATO. In the interest of time I'm just going to submit a statement and ask that it be accepted as if read in its entirety and I would note that the chairman is exactly correct that it's important for us I think to address the question of what powers the State should have, shouldn't have, what manner should they exercise them, under what control, under what supervision, what about the adequacy of that. I mean, that's something that we should look at.

I think most of the States have done a pretty good job as it relates to regulation. There may have been some that have not had the kind of regulation that is necessary. I think that's something that the chairman is absolutely correct on. As we move forward to address this major problem, as we commit tens of billions of dollars of resources to this, taxpayers' moneys, certainly where there are areas that are in need obviously to address the shortcomings we should certainly focus in on them and I commend the chairman for making these observations.

[The complete prepared statement of Senator D'Amato follows:]

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, today's witnesses are uniquely qualified to present a perspective that has not yet been fully heard during this excellent round of hearings on the FSLIC crisis.

Today is an excellent opportunity to point out that in the vast majority of States, savings institutions have behaved responsibly and much credit for this fine record goes to solid regulation at the State level.

Having said that, I am also compelled to point out that some State governments made the same mistakes as were made at the national level by linking expanded powers with reduced resources for regulation. Mr. Chairman, this is a mistake we must keep in mind as we move forward with this legislative package. Primarily, we must focus on adequate regulation as a function of two things: authority and resources.

We have the ability to grant additional regulatory authority in this bill and the Bush plan is an excellent step in that direction. We must also be certain that we give the regulators the resources to conduct the increased level of supervision that the bill mandates. In particular, we must be certain that regulators have the ability to pay the necessary salaries to attract and retain the quality of examiner that we now know is necessary for adequate regulation. A cadre of dedicated, experienced, well-paid bank examiners is the front line of protection against the recurrence of this terrible situation.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the Senator.

Senator Heinz.

Senator HEINZ. Mr. Chairman, I join you in welcoming today's witnesses from the State bank and thrift regulatory groups. I think our witnesses today are concerned with the vitality of the dual banking system. Under this system State governments have the right to grant broad powers to depository institutions, but when huge losses occur as a result of these powers the Federal Government has the obligation to pick up the tab.

Now, Mr. Chairman, I support the dual banking system, but we must also have a dual ranking system. Under this approach the Federal deposit insurance system and the taxpayers rank first over the powers of our depository institutions.

No one knows better than the Members of Congress that it's no fun to come in second in a two-man race, but if we don't give the Federal deposit insurance system the winning edge, everyone is bound to lose.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Pressler.

Senator PRESSLER. Thank you, Mr. Chairman.

I have two other committees currently meeting and I must excuse myself, but I will read very closely especially the statement of Mr. Seymour regarding the Federal Home Loan Bank Board regarding the 6 percent capital requirements. I think on small savings and loans such as exist in my State of South Dakota this could be a very onerous burden.

One of the summary statements of Mr. Seymour is that the Federal Home Loan Bank Board should be asked to expeditiously provide specific information on the number of insolvencies that would be created by the bill's 6 percent June 1991 capital requirement. On the basis of that information Congress might consider a longer or more flexible phase-in of the requirement.

I am not necessarily advocating that, but I think that is an issue especially affecting some of our smaller financial institutions that we need to consider very closely.

Mr. Chairman, I may have questions for the record which I would ask unanimous consent that they be submitted to the witnesses for answering in writing.

The CHAIRMAN. Very well. Thank you, Senator Pressler.

Before we start, I have a statement from Senator Dixon for the record.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the Senate Banking Committee approaches the conclusion of its comprehensive hearings on the problems of the thrift industry. I look forward to hearing the testimony of representatives from the State bank and thrift regulatory community: Eugene Kuthy, John Seymour, and William Crawford.

I would like you to extend to Mr. Seymour a special welcome. We appreciate your coming here to testify. Mr. Seymour is the commissioner of savings and loans in my home State of Illinois and is also a member of the board of the American Council of State Savings Supervisors.

As this is the committee's next to last day of hearings, I wish to comment again on the budgetary issues involved in the Treasury's reform, recovery, and enforcement legislative proposal.

The Congressional Budget Office testified the week before last that conventional budget accounting techniques should cause the $50 billion of REFCORP bonds to be counted on-budget. I have stated before that I believe that funding should be on-budget. If CBO's conclusion is correct, Congress will have to pass a budget waiver.

Let us do this the right way. Since we need a budget waiver, let's pass that, put the funding on-budget, and get a budget agreement with the administration.

I believe we should do everything we can to minimize the public cost of the legislation. If the borrowing is done by Treasury rather than REFCORP, American taxpayers will save between $125 and $200 million a year, or a total of around $4 billion over the lifetime of the bonds. I believe we should try to save that money.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me now introduce our two witnesses today. Our first witness will Mr. Eugene Kuthy. Gene Kuthy is the chairman of the Michigan Financial Institutions Bureau. He is here representing the Conference of State Bank Supervisors. I take a particular pleasure from having Mr. Kuthy before us today because he is a friend and colleague of long standing and I think clearly has done an outstanding job in carrying out his responsibilities in the State of Michigan. So, we are especially pleased to have you before us today.

And after Mr. Kuthy has testified, we will hear from Mr. John Seymour, who is from the board of directors of the American Council of State Savings Supervisors and the Commissioner of the Savings and Loan Commission located in Springfield, IL.

Mr. Kuthy, we're delighted to see you, and we'd like to hear from you now.

STATEMENT OF EUGENE W. KUTHY, COMMISSIONER, MICHIGAN FINANCIAL INSTITUTIONS BUREAU, REPRESENTING THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. KUTHY. Thank you very much, Senator.

Mr. Chairman and members of the committee, my name is Gene Kuthy, commissioner of Financial Institutions in the State of Michigan and immediate past president of the Conference of State Bank Supervisors, on whose behalf I am here to testify.

The Conference of State Bank Supervisors or CSBS as it is known, is the professional organization of State regulators who represent 9,500 State-chartered banks throughout the United States, both commercial banks and FDIC-insured savings banks.

At the outset I want to get something off my chest. I testify here today as a State regulator, but I am not here to whitewash wrongdoers who deserve to be drummed out of the corps. I strongly believe that all of those who contributed to the S&L crisis and the S&L mess we are in today ought to be punished and prevented from doing it again. That goes for State regulators as well as S&L managers and owners and Federal regulators.

The real challenge before this body today, in my opinion, is to get the misguided regulators and S&L owners and managers to straighten up their act without putting the whole State banking system in a straitjacket.

We are desperately seeking a solution to this $100 billion problem, but we are not seeking and strongly recommend against a dissolution of the 200-year-old dual banking system in this country.

The bill before you correctly focuses on the savings and loan crisis and the needed reforms in the thrift regulatory system. We exhort you to limit the scope of the bill before you to these pressing problems.

S. 413 demonstrates two lessons learned from the savings and loan crisis. First, that adequate capital is absolutely necessary for safe and sound operation of financial institutions.

Second, that the insurer and chartering agents of financial institutions should be independent of each other.

Nothing, Senator Riegle, could demonstrate more than the experience of a Michigan Senator or a Michigan regulator using the homily of a Michigan manufacturing operation. You don't have the quality control manager reporting to the production manager, an ancient time-honored thing we learned a long time ago.

However, the role of appropriate Federal regulator as it's spelled out in the statute proposed before us for State chartered savings and loans should go to the FDIC or alternatively the SAIF and not to the Federal Home Loan Bank System.

The FDIC serves this function for nonmember State chartered banks and should as well for State chartered savings and loans. It simply doesn't make sense to give the FDIC insurance authority over these institutions, but instead, give primary Federal regulatory authority to the Federal Home Loan Bank Board.

The authority of the FDIC under this statute would be given to force specific activities of State chartered savings and loans into subsidiaries and, frankly, is too broad.

Clearly, we do not disagree with that safe and sound and inherently good concept. These activities should be addressed on an institution specific basis as is currently the case for State chartered banks, a system that works well.

To conclude, Congress may be able to help us sort out this S&L debacle, but no fundamental long-range change will take place without commitment—commitment by the State and Federal regulators, and I mean genuine, gutsy commitment, not the kind possessed by a veteran of 25 kamikaze missions.

I pledge my commitment to help you, this committee, the Congress, this country make this happen. I know I can speak as well for my colleagues in the 50 States and that I can also pledge their resources that presently consist of over 2,000 professional commercial bank examiners supported by $145 million in State banking department budgets.

I thank you very much, Mr. Chairman.

[The summary and complete prepared statement of Eugene W. Kuthy follow:]

STATEMENT OF EUGENE W. KUTHY

ON BEHALF OF

THE CONFERENCE OF STATE BANK SUPERVISORS

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

MARCH 16, 1989

Mr. Chairman, members of the Committee, I am Eugene Kuthy, Commissioner of Financial Institutions for the State of Michigan and Immediate Past President of the Conference of State Bank Supervisors, on whose behalf I am testifying today.

The Conference of State Bank Supervisors (CSBS) is the professional organization of state officials who charter, examine, supervise and regulate the approximately 9,500 state-chartered commercial and FDIC-insured savings banks in the nation. Created in the early 20th century as a clearinghouse of ideas for state bank supervisors on common problems, CSBS has evolved into the most significant single source of education and research services aimed at strengthening individual state banking departments.

We are pleased to have the opportunity to testify before the Committee on the Administration plan to address the current savings and loan crisis.

We applaud the efforts of the Administration and of this Committee to move quickly and firmly to address the savings and loan crisis and to implement disciplined savings and loan regulation to prevent a repeat crisis. The Administration plan provides a solid base for Congressional consideration.

We also believe the plan hits the mark by focusing primarily on the needs of the savings and loan crisis. By doing this, the Administration has avoided many controversial bank reform issues faced in the last Congress. We encourage you to take this tack as well, and concentrate on producing legislation quickly to meet the current crisis in the savings and loan industry.

Before I begin discussing the Administration plan, let me take a few moments to report to you on the health of state-chartered banks and the regulation of these institutions.

State Banking System

The condition of the state bank system is good and improving. Capital ratios for state banks continue to exceed those of national banks. The failure rate of state banks has broken the upward trend which dominated the 1980's and fell in 1988. In fact, the current failure rate for state banks is significantly below that of national banks (see attached chart).

Banks, both state and national, have felt the impact of the severe economic recession in the Southwest. We expect to see a number of bank failures in that region in 1989. Especially hard hit is Texas, where we expect to see approximately 100 bank failures this year, with half of those being state-chartered. However, we appear to have weathered the worst of the economic storm in this region. Banks' abilities to survive without the enormous losses incurred in the savings and loan industry is the result of entering the period with relatively strong capital and disciplined supervision.

The primary supervision of state banks is carried out by state banking departments. The FDIC also participates in the supervision of banks as a second line of defense to protect the interests of bank customers and the public as providers of deposit insurance.

States take the responsibility for regulating the institutions they charter very seriously. Department budgets have increased 25 percent and the number of bank examiners in the field has increased by 15 percent in the past four years. When you compare these increases to the seven percent reduction in the number of state banks supervised, the regulatory coverage has greatly improved.

The quality of examiner has also improved during this period. Two measures of quality are the salaries and the training the examiners receive. Salaries of beginning examiners vary widely, as do all salaries of state bank department personnel, due to local cost of living. The average starting salary for a state bank examiner was $21,340 in 1987, increasing 24.5 percent from 1983. This same trend was experienced in the salaries of seasoned examiners. 1987 average salaries were $31,224, representing a 20.5 percent increase over the same period.

Education and training of bank examiners has received a great deal of attention from state banking departments. The deregulation of interest rates with the elimination of Regulation Q and technological innovations have increased the complexity of bank supervision. To meet this challenge, state bank supervisors supported (through the Education Foundation of State Bank Supervisors) training opportunities for nearly 1300 state banking department personnel in 1988. The numbers of state banking department attendees in these training programs has doubled since 1984 and nearly tripled since 1978. This level of training could not be attained without the generous support of state-chartered banks, who support the Education Foundation of State Bank Supervisors, and the FDIC and Federal Reserve, who provide scholarships for state bank examiner training and opportunities for attendance at their schools.

Cooperation with the FDIC and Federal Reserve extends beyond the training area into the actual supervision and examination of state-chartered banks. This cooperative relationship provides the checks and balances intended by Congress in our banking system and allows for the experimentation and innovation that has become synonymous with the dual banking system.

State-driven innovations have become the standard in bank regulation rather than the exception. Interstate expansion is a recent example of this innovation. Currently 45 states have interstate banking laws on the books, with 20 now open for full interstate banking.

State banking departments have developed regional councils to coordinate the examination of bank subsidiaries of multistate holding companies. Federal banking agencies participate in these meetings and through this combined effort we can get an accurate picture of the health of a multistate holding company. We were pleased to see that the FDIC suggested a similar program at the federal level in its recent study of deposit insurance.

States have also led the way in meeting the needs of consumers of bank services. Many, if not all, of the recent changes in bank regulation and services began and were developed at the state level. These include NOW accounts, electronic funds transfers, check-hold limitations and community reinvestment requirements. In developing these new directions in banking, the dual banking system is achieving the goal that Congress has envisioned: being laboratories for experimentation.

States are continuing to innovate and experiment. Real estate and insurance activities are two areas that have received a good deal of attention. Currently, 27 states have expanded real estate activities for their state-chartered banks and 12 states have expanded insurance powers. Some of these laws have been on states' books for more than a hundred years; others are fairly new. Two recent laws are good examples of the innovations in these areas. Last year, Vermont passed a law which allowed state banks to invest up to 2% of their assets in low-income housing development. There is a desperate need for affordable housing in Vermont, and the state hoped to increase supply by allowing bank investment. Banking's incentive was that the investments helped meet Vermont's community reinvestment requirements and qualified for the low-income housing tax credit.

The second innovation is one you have heard a good deal about. The recent passage of California's Proposition 103 allowed state-chartered banks to offer insurance as agents. The people of California perceived a lack of competition in the offering of insurance products. By authorizing bank participation, they are looking for increased competition that will lead to a reduction in the cost of insurance. The California Banking Department recently outlined procedures for state bank participation in these insurance agency activities.

State bank involvement in these nontraditional activities has been limited. This is a result of the conservative nature of both the banking communities and the regulators. State bank supervisors and the FDIC continually review the use of these powers and their impact on safety and soundness. The FDIC withdrew a proposed restrictive regulation on real estate activities of state-chartered banks in late 1987, stating that they had no systemwide concerns with the current authorizations or level of activity. They further stated that they would continue to study and monitor these activities. We agree with their findings, and we too will continue to watch these activities closely.

State-Chartered Savings and Loans

A great deal of discussion over the current savings and loan crisis has focused on the role that state-chartered institutions have played. As the regulator of both thrifts and banks in my state, I hope to share with you a new perspective on this debate. An accurate understanding of primary causes of the savings and loan crisis is a prerequisite to an analysis of the most appropriate resolutions.

First of all, statistical data must be used objectively. Texas savings and loans failures appear to be overwhelmingly among state-chartered institutions, but the failure rate of Texas state-chartered savings and loans is not proportionately higher than the failure rate of federal savings and loans in Texas.

There is a perception that savings and loans have rushed to take advantage of state powers. This is untrue. Since 1978, 311 state savings and loans have converted to federal charters voluntarily while only 55 have converted from federal to state. There have been 44 involuntary state-to-federal conversions due to merger or other regulatory action, which is consistent with the information the Senate Banking Committee published last year. The primary reason these savings and loans converted to federal charters was to take advantage of the powers granted in the Garn-St Germain Act or to escape more stringent regulation at the state level.

The Garn-St Germain Act allowed federal savings and loans to hold up to 40 percent of their loan portfolio in non-residential commercial real estate loans, and up to 10 percent in secured or unsecured commercial loans. Many states do not have "wild-card" statutes that produce automatic parity with federal law. In order to take advantage of these powers granted in Garn-St Germain, many savings and loans in these states converted to federal charters.

Several states either required higher capital levels or refused to accept regulatory accounting principles, or RAP, for capital adequacy. Most state savings and loans with low capital converted to federal charters in these states. In some cases, a state regulator would attempt to close a savings and loan due to lack of capital only to find it rechartered as a federal savings and loan.

The majority of the losses experienced in Texas were the result of commercial real estate lending, primarily in the area of Acquisition, Development and Construction (ADC) loans. The ability to make these loans was granted in the 1982 Garn-St Germain Act. It was not until 1985 that these loans were redefined by the Bank Board as direct investments. This redefinition came after most of the savings and loans' abuses of these loans had taken place. The inclusion of ADC loans as direct investment also inflated the measure of direct investment, making it nearly impossible to assess the impact of direct real estate investment (non-ADC loans) on savings and loan performance.

We do not deny that there was a breakdown in regulation of the savings and loan industry. This fact has been well-documented before this committee. We do take issue with the assertion that it was primarily state regulation of savings and loans that broke down. The Federal Home Loan Bank Board and the FSLIC as one has been an extremely dominant regulator. Consequently, cooperation between state and federal savings and loan regulators has been nonexistent--as have checks and balances enjoyed by our own dual banking system. Federal and state examiners usually examined savings and loans together, but shared neither duties nor information during the exam.

Had the Bank Board been asserting its role as insurer rather than as promoter of housing, some of these problems would not have occurred. The Bank Board apparently translated its role as promoter of housing to one of maintaining a savings and loan industry. This attitude inhibited the Bank Board from closing institutions or taking other regulatory actions necessary to limit the risk to the insurance fund. We do not lay the entire savings and loan crisis at the feet of the Bank Board, nor do we lay the regulatory breakdown at their feet. The savings and loan regulatory systems in several states were similarly unprepared for the changes that took place in the economy and in the industry. The states and the Bank Board both share the blame for regulatory inadequacy in the savings and loan industry.

State savings and loan powers have become the whipping boy of the savings and loan crisis. We will grant you that a few states went beyond what is now considered reasonable. We must point out, however, that it was the Bank Board in the early 1980's who promoted the idea that the solution to the savings and loan crisis was capital forbearance, expanded lending authorities and growth. The Garn-St Germain Act, which greatly expanded lending authority of savings and loans while virtually eliminating the need for capital through net worth certificates, was enacted prior to most liberalizations by the states. Adoption of regulatory accounting principles at the same time further reduced industry incentives to hold real capital. The states which went beyond the authorizations contained in Garn-St Germain did so primarily by increasing the percentage of assets that could be dedicated to a certain power.

The Administration Plan

The Administration plan calls for the continuation of a separate savings and loan industry. It also anticipates a continuation of a system of state-chartered savings and loans similar to that of state-chartered banks. We believe that the benefits of the dual banking system are needed in the savings and loan area. In fact, one innovation developed at the state level for savings and loans--the adjustable-rate mortgage--was rejected by the federal regulators and Congress in the early 1970's. If the adjustable-rate mortgage had been in use in the 1970's and early '80's, we might not have experienced the depletion of net worth in the savings and loan industry that resulted from the interest rate mismatch.

What we have learned from the current savings and loan crisis is twofold. First, when you deplete the capital of a financial institution, the management of that institution is likely to take on extraordinary risk. Had the savings and loan institutions been required to amass capital before growing or engaging in the new activities authorized by legislation, much of this problem could have been avoided. Capital in insured institutions serves as incentive for risk-adverse management and as a check on growth; it brings market discipline to the institution, is a deductible against insurance loss, and is the best measure of safety and soundness. When an institution's capital is depleted, that institution should be closed as quickly as possible.

The second lesson is the need for an independent insurer. We have maintained that the insurer should be separated from the primary chartering and primary regulatory agent for all depository financial institutions. Had the FSLIC been independent from the Bank Board and had adequate financing and enforcement powers, the savings and loan crisis would not be as severe.

The plan calls for the FDIC to administer the Savings Association Insurance Fund (SAIF). However, the plan gives the role of "appropriate Federal regulator" of state-chartered savings and loans to the Federal Home Loan Bank System. In doing this, the plan moves the administration of the insurance fund without giving the FDIC--or SAIF--the responsibility over state savings and loans that it has over state banks. This proposal is flawed for several reasons.

The FDIC has an excellent track record in overseeing the activities of state-chartered banks for insurance purposes. We can assume that this good experience would carry over to state savings and loan regulation. On the other hand, the Bank Board's record in overseeing state savings and loans has been dismal. We are unconvinced that the other changes to the structure of the Bank Board would overcome this record.

Also, the Bank Board is not the insurer of these state institutions and therefore has different motivations from those an insurer would be expected to have. We realize that the mission of the new Bank System has been expanded in this legislation to include a concern for safety and soundness. You do not, however, change the attitudes, experience and activities of several thousand employees by adding a few words to an agency's charter.

We would urge the members of this committee, especially those who have called for a separation of the FSLIC from the Bank Board, to correct this flaw and place the Federal oversight of state-chartered savings and loans under the deposit insurer, the FDIC in the Administration's plan.

Our other concerns are more specific to the legislation. First, Section 218(5)(3)(A) gives the FDIC the authority to force specific activities into subsidiaries. The FDIC currently has similar authority over state banks on an institution-specific basis. We strongly object to the use of this authority on a general basis as is contemplated for savings associations. This authority could become a disincentive for states to authorize new activities that could be beneficial to their citizens.

Our second concern is with the new definition contained in the bill for "in danger of default" in Section 204(7)(x)(2). Currently only chartering agents can declare a bank closed. These terms could be read strictly to give the FDIC the authority to declare a state bank in default or in danger of default, preempting the traditional authority of the state--and presumably eventually the national bank--chartering agent. We are not aware of any cases in which there have been failures on the part of state supervisors to close failing banks or to delay closings of banks which have indeed failed. We believe that this may be a drafting error and urge the Committee to review this section.

Our final concern is with the definition of "savings association" contained in Section 204(7)(a). This definition would include all current FSLIC-insured institutions as well as all federal and state-chartered savings and loans. The section would apparently exclude the FDIC-insured state savings banks from the first part of the definition. However, the definition is left to the discretion of the FDIC. We believe the treatment of FDIC-insured state savings banks should be clarified by explicitly stating that the FDIC cannot find that any institution falling under the definition of FDIC-insured state bank is a savings association.

We note that the plan includes a study of deposit insurance and bank regulation. While the state supervisors are not specifically named as participants in this study, we look forward to working with the administration on producing this study.

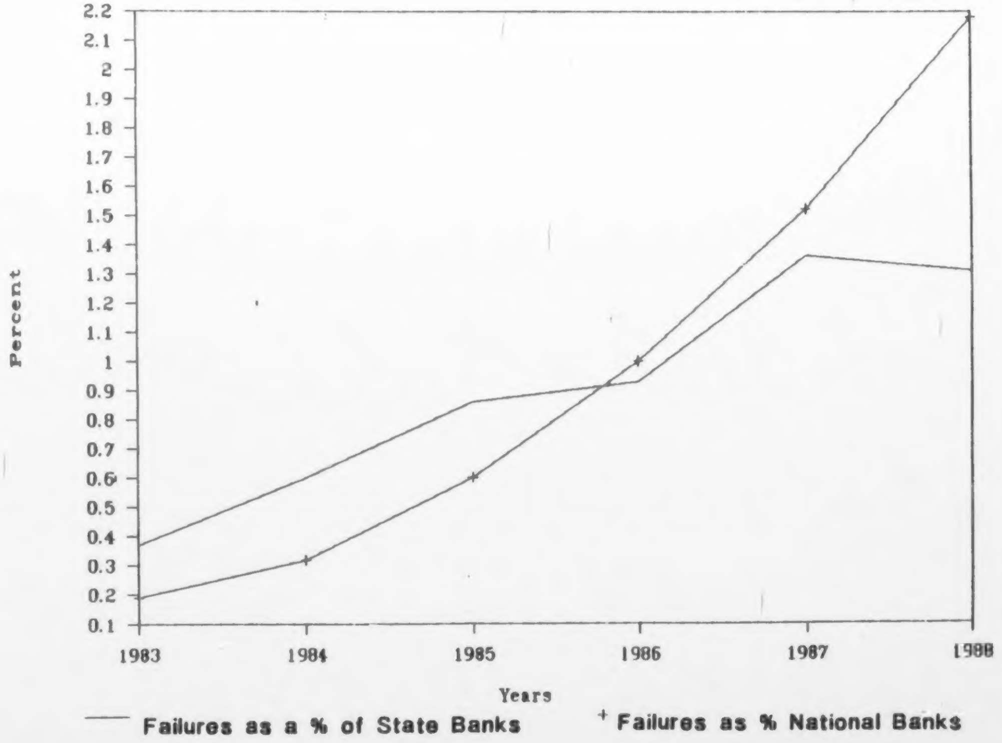
Summary

In closing, I would like to reemphasize our support for the expedited treatment that the Administration and Congress have given the savings and loan crisis this year. We believe the plan hits the mark in addressing primarily the problems of the savings and loan industry. The state banking system is healthy and we look forward to the challenges that are before us in the 1990's. Our primary concern with the pending legislation regards the incomplete separation of the savings and loan insurance function from the Bank Board, and we strongly encourage Congress to correct this flaw by placing the federal oversight of state-chartered savings and loans in the FDIC.

Thank you for your time and interest. I will be happy to answer any questions.

COMPARISON OF FAILURES OF STATE AND NATIONAL CHARTERED BANKS
1983 - 1988

(Includes Assisted Transactions for the years 1986-1988)



The CHAIRMAN. Thank you, Mr. Kuthy.

Mr. Seymour, before you start, let me acknowledge that Senator Shelby has come in. Senator Shelby, did you have an opening comment you wanted to make?

Senator SHELBY. Mr. Chairman, I have an opening statement I would ask unanimous consent be made a part of the record.

The CHAIRMAN. Very good. Thank you, Senator Shelby.

[Committee insert of Senator Shelby's opening statement follows:]

STATEMENT BY SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I commend you for scheduling this hearing on a most important issue. The debate over the risk posed to the Federal insurance system by State authorized activities must be settled before we complete legislation resolving the thrift crisis.

There is a propensity to overreact. We could effectively abolish a dual banking system by prohibiting States to authorize activities that are different than those authorized by the Federal Government. If one is convinced that State authorized activities are responsible for the current catastrophe, a change such as this would provide greater protection to the Federal insurance system.

However, Mr. Chairman, I believe that the jury is still out on this issue. In my State, there is only one State chartered institution and this thrift has 12 percent capital. Clearly this thrift has yet to cost the insurance system a dime, unlike severally federally chartered S&L's in my State that will cost the FSLIC a pretty penny.

Traditionally, the dual banking system has provided the financial services industry with a laboratory to test innovative new products and services, without exposing the entire financial system to risk. I would hate to see us lose this testing ground under the guise of improving the system.

However, the present system in which State authorized activities can expose the insurance system to excessive risk without check, is wrong. The Federal regulator should have the authority to limit State activities where these activities demonstrably expose the system to potential liability. Permitting State authorized activities only in sufficiently capitalized institutions would also provide protections to the deposit insurance system.

Mr. Chairman, I am glad for today's hearing and I look forward to the evidence that our witnesses can provide on the pro's and cons of State authorized activities.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Seymour.

STATEMENT OF JOHN D. SEYMOUR, BOARD OF DIRECTORS, AMERICAN COUNCIL OF STATE SAVINGS SUPERVISORS, COMMISSIONER, SAVINGS AND LOAN COMMISSION, SPRINGFIELD, IL

Mr. SEYMOUR. Thank you, Mr. Chairman.

I am Jack Seymour. I'm a member of the board of directors of the American Council of State Savings Supervisors, ACSSS, but I am also the Commissioner of Savings and Loans for the State of Illinois.

Both for ACSSS and myself, I'd like to thank you for the opportunity to testify today and address this issue before us.

As with any crisis that's long on question and short on answers, much of the debate over the thrift crisis has been in the form of broad accusations, indictments, and sensational anecdotal revelations, and rampant finger pointing.

Quite frankly, the truth is that there's no single cause or simple cause of the current thrift crisis. Instead, the crisis has been precipitated by the adverse effects of several factors. Some of these are controllable. Some of them have not been. All of these, however, have worked against the safety and stability of the industry.

It's important to note that many of the industry regulatory and legislative decisions that contributed to the thrift crisis, while questionable or wrong in retrospect, were generally rational responses to changing market demands and conditions at the time. Some of these fundamental causes were and still are with us—uncontrollable macroeconomic forces, a well-intentioned but poorly planned deregulatory effort, excessive liberal investment authority at Federal as well as at State levels, poor regulatory enforcement, undue industry influence on the process of government, and outright mismanagement, greed, fraud, and incompetence.

The truth has to really be seen also in the context of all of these problems being influenced overall by two significant factors. The first was a stilted, inflexible Federal regulatory structure premised upon desire for strict compliance with broad regulations that were designed to address the lowest common denominator of the industry.

At a time when the unique problems of the industry called for picking off the worst offenders with a regulatory rifle, regulators were armed solely with the compliance shotgun, a weapon that once fired would likely inflict damage on those innocent well-managed thrifts standing near the scoundrels.

Even as the Federal regulatory system trudged through the cumbersome process of promulgating rules and regulations today to address yesterday's concerns, new problems were cropping up to render the new regulations functionally obsolete and misdirected.

Second, unlike the FDIC, the Federal Savings and Loan Insurance Corporation and the Home Loan Bank Board were unwilling to make use of the State supervisory system to correct admitted manpower shortages. Whereas State bank regulators have been partners in the regulatory process with the FDIC, the Home Loan Bank Board has insisted on duplicating everything State regulators do. Until the past few years, the Bank Board increasingly resisted the contributions State regulators could make toward resolving the problems of insufficient manpower and expertise.

Mr. Chairman, ACSSS applauds the resolve of this committee to move so quickly on the issue by scheduling markups. We also commend the administration for facing up to the problem of the FSLIC as soon as it did.

We are supportive of the administration's bill. As Congress begins, however, to consider the administration's bill, we recommend that some improvements be considered in order to maximize the industry's ability to contribute to the cost of resolving the crisis and to preserve the benefits to consumers in the general economy of our dual banking system.

Additionally, in order to put into place regulatory structure that will provide clear lines of authority and make better use of existing resources both at the Federal and the State level.

I'd like to go through these specific points that we have in mind. First, the Federal Home Loan Bank Board should be asked to expeditiously provide specific information on the number of insolvencies that would be created by this bill's 6 percent June 1991 capital requirement. On the basis of that information, Congress might consider a longer and more flexible phase-in of the requirement.

Second, action should be taken to facilitate the ability of solvent thrifts to raise their capital to a 6 percent level by, for instance, removing present impediments to mergers with or acquisitions by banks. Additionally, facilitating changes in forms of ownership should be considered as a part of this bill, such as mutual holding company structure or reconsidering the 10-year phase-out of good will being contemplated by the regulators.

Third, activities not permitted to national banks that are currently conducted in thrift subsidiaries should be grandfathered from the provisions excluding such investment from the thrift's capital. The grandfathering might be made subject to a specific review of such activities in consultation with State regulators and accompanied by a phase-out of such activities where such is deemed advisable.

Fourth, specific standards should be spelled out against which State authorized activities would be measured for their safety and soundness implications. Moreover, the bill should provide for specific notice to and contact with State regulators before a State activity can be determined a threat to either the FDIC or to SAIF, and formal expeditious appeal processes should be put into place when actions result in the vetoing of State authorized activity.

Fifth, the examination system created by this bill should more closely resemble the one currently existing between the FDIC, the Comptroller, and State regulators. In order to more effectively utilize the manpower and expertise of the nationally certified State regulators, this model, the bank model, should be considered as the one to be applied in savings and loan regulation.

Sixth, Congress should encourage the national certification of State regulators and regulatory systems in order that they can assure that we will continue to effectively involve those closest to the problems in our attempts to understand, anticipate, and resolve future threats to our savings and loan industry.

Finally, we would urge the elimination of the unnecessarily restrictive and unworkable provision of section 302(a) dealing with loans beyond a 100-mile radius of an institution's principal office, a provision that continues to perplex us.

Mr. Chairman, we wish to make it clear that the American Council of State Savings Supervisors strongly supports the efforts of this committee to protect the insurance fund from either excessively permissive or overly restrictive actions at the State or Federal levels. We take our responsibilities as regulators and insurers of safety and soundness very seriously and we look forward to working with Congress in this regard over the next several months and years.

Though you have made a statement about the major causes of the problem, I hope one of the things we can end with today is at least an understanding that there were many causes to this problem. We are not in a position of access to defend poor regulation at the State level and, additionally, we agree with you that the Federal insurance company simply should have the authority to determine what it is it's insuring. That makes sound sense to us.

But by the same token, Mr. Chairman, the State system has been the source for some of the best and most innovative ideas presently in the system and for a choking off of the State system we would lose instruments that quite frankly have made it possible for this problem not to be any larger than it presently is.

I'd point out just a few—State chartered systems have produced adjustable rate mortgages, NOW accounts, stock ownership came from States, deposit account concerns and consumer lending—that is, the consumer lending provisions generally are initiated at State law and picked up by the feds. Statewide branching is a concept occurring at the State level. The Community Reinvestment Act was a provision that came out of State regulated system. And many consumer protection provisions presently in Federal law originated in States.

The dual system continues to be an institution which has provided new ideas and new opportunity. If these ideas are not safe and sound, we are behind you 100 percent, but we cannot, Mr. Chairman, choke off innovation in the process.

Thank you.

[The complete prepared statement of John D. Seymour follows:]

STATEMENT OF JOHN D. SEYMOUR

MEMBER, BOARD OF DIRECTORS

AMERICAN COUNCIL OF STATE SAVINGS SUPERVISORS

AND

COMMISSIONER OF SAVINGS AND LOAN ASSOCIATIONS, ILLINOIS

BEFORE THE SENATE BANKING, HOUSING

AND URBAN AFFAIRS COMMITTEE

MARCH 16, 1989

American Council of State Savings Supervisors
Norman E. D'Amours, Executive Director
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Chairman Riegle, Senator Garn, and distinguished members of the subcommittee. My name is Jack Seymour, and I serve on the Board of Directors of the American Council of State Savings Supervisors (ACSSS). I am Commissioner of Savings and Loans in the State of Illinois. Both for ACSSS and myself, I thank you for this opportunity to testify today.

The American Council of State Savings Supervisors (ACSSS) is the national association of state savings and loan (S&L) regulators. Due to their regulatory positions and responsibilities within the thrift industry, ACSSS members have had a unique opportunity to observe first-hand the rapid changes -- and resulting problems -- that have beset the industry in the last decade. Drawing on the collective observations of its members and their inherent geographic and regulatory diversity, ACSSS is in a prime position to offer valuable input and insights on the problems facing the thrift industry and to provide a perspective on the issues that must be addressed in order to resolve these problems.

CAUSES OF THE SAVINGS AND LOAN PROBLEMS

As with any crisis that is long on questions and short on answers, much of the debate over the thrift crisis has been in the form of broad accusations and indictments, sensational anecdotal revelations, and rampant finger-pointing.

Unfortunately, a vocal group of accusers, some of whom presided over the growth of the crisis, have pointed to the state regulatory system as the major cause of the current thrift crisis. In the view of that group it is the dual-chartering system that is to blame for all of the turmoil of the past decade! We at ACSSS hope that a more careful look at this problem will quickly demonstrate the error of that charge.

The truth is that there is no single, simple cause of the current thrift crisis. Instead, the crisis has been precipitated by the adverse affects of several factors -- some controllable, some not -- that have worked against the safety and stability of the industry.

It is important to note that many of the industry, regulatory, and legislative decisions that contributed to the thrift crisis, while questionable or wrong in retrospect, were generally rational responses to changing market demands and conditions. Several are worthy of comment:

Deregulation. In the early 1980's, deregulation was hailed as the savior of the industry. Still reeling from the effects of disintermediation and the interest rate mismatches of the late 1970's and early 1980's, the thrift industry perceived deregulation and its resultant expansion of powers to be the road to stability. The disparity between what the so-called money markets funds were paying and the regulated rates offered by depository financial institutions resulted in levels of disintermediation which detrimentally affected the savings and loan industry to a greater degree than other depository institutions. In reaction to this problem, Regulation Q was repealed. However, the deregulation of the liability side (deposits) of the balance sheet solved the disintermediation problem, but created an asset-liability management problem. Failure to address this problem simultaneously by concurrent deregulation of asset powers (investments by savings and loans) for the savings and loan industry further exacerbated their financial dilemma.

By the time meaningful asset deregulation did occur many institutions were already in serious financial difficulty. In June of 1981 Federal Home Loan Bank Board (FHLBB) Chairman Richard Pratt stated that one-third of the industry was not viable. Many savings and loans took imprudent risks to attempt a recovery from impending failure. Many were simply not prepared to compete in a deregulated environment that permitted and then penalized poor management practices.

Regulators, too, were unprepared for the tests of deregulation. Some of them mistakenly thought deregulation required a lessening of supervision when, in fact, the opposite was true. As the industry moved quickly into new and unfamiliar strategies and procedures, and as some managers with fraudulent, greedy and otherwise criminal intent seized upon the opportunity, regulators were caught understaffed, undertrained, underfunded, and generally unprepared to address the new set of emerging regulatory issues. This was a prescription for disaster.

Economic Forces. Unfortunately, deregulation threw the industry into the marketplace when whole regions of the country were entering into a sharp economic downturn. This recession was especially pronounced in those areas of the country that had experienced the biggest economic expansion in the late 1970's -- primarily the energy-patch states of Texas, Oklahoma, Colorado, and Louisiana -- and which therefore had attracted a disproportionate share of savings and loan investments from all parts of the country. When these investments declined with the

regional economies, thrifts across the country were encumbered with losses that continue to drag balance sheet performance today.

With the economic downturn came an end to the high levels of inflation that had been experienced in the late 1970's. While universally perceived as a negative factor for the economy as a whole, inflation had actually been beneficial to those marginally managed institutions in the industry with weak loan underwriting procedures. The inflation-fueled increases in real estate property values nationwide had been the salvation of poorly underwritten loans. Once inflation subsided, the accompanying stagnation or erosion of property values exposed the underlying weaknesses of many loans.

State Legislators. Without a doubt, isolated instances of overzealous state legislatures share some of the blame for the present industry crisis. State legislators sometimes did succumb to intense local pressure to enhance the value of state charters through excessively liberalized operating and investment authority. The effects of state power enhancement are mixed, however, and most state institutions were able to use these expanded powers positively as a means of diversification and eventual profitability. Results in other states, especially those states with macro-economic factors working against them, were less successful, and in some cases disastrous. But the fact that 75 percent of all thrift losses have occurred in only four states underscores the fact that most states have been responsible in modifying and supervising their state chartered institutions. Even in those four states many of the S&L's are today profitable and viable institutions.

Industry. Changes to the savings and loan playing field did not come without intense lobbying from the industry itself. Typically, industry lobbying efforts of the early 1980's called for the expansion of powers with minimal regulatory "interference." The industry lobby thus mistakenly relied on the premise that thrift management could cope with the rigors of the marketplace through prudent use of expanded powers. Unfortunately, the operating experience of the thrift industry over the past several years indicates that many managers were impelled by near or actual insolvency or by greed, into taking unacceptable risks, engaging in fraudulent and criminal actions, or simply were ill prepared for their journey into the land of commercial lending, large scale Acquisition, Development, and Construction (ADC) lending, direct property development, and other areas. This overestimation of the capabilities of the industry was, in retrospect, a grave error.

Regulators. Finally, savings and loan regulators must accept some portion of the blame for the current state of the industry. Neither state nor federal regulators were totally prepared for the profound and fundamental changes in the market environment and industry structure that occurred in the early 1980's. During those tumultuous years, regulators possessed neither the manpower nor the expertise to effectively oversee the new operating strategies being developed by savings and loans. In fairness it must be noted that some regulatory agencies were requesting increased resources at this time but the prevailing opinion in Washington and elsewhere was that "deregulation" required a deemphasis of the oversight and supervisory functions.

This problem was compounded by two factors. The first was a stilted, inflexible federal regulatory structure premised upon a desire for strict compliance with broad regulations that were designed to address the lowest common denominator of the industry. At a time when the unique problems of the industry called for picking off the worst offenders with a regulatory rifle, regulators were armed solely with a compliance shotgun, a weapon that once fired, would likely inflict damage on those innocent well-managed thrifts standing near the scoundrels. Even as the federal regulatory system trudged through the cumbersome process of promulgating regulations today to address yesterday's concerns, new problems were cropping up to render the new regulations functionally obsolete or misdirected.

Second, unlike the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC) and the FHLBB were unwilling to make use of the state supervisory system to correct admitted manpower shortages. Whereas state bank regulators have been partners in the regulatory process with the FDIC, the FHLBB has insisted on duplicating everything state regulators do. Until the past few years, the Bank Board increasingly resisted the contributions state regulators could make toward resolving its problems of insufficient manpower and expertise.

Misguided regulatory directives also compounded the problems. In the early 1980's, the falling profitability and capital levels of the industry caused by the severe interest rate mismatches of the late 70's led the FHLBB to stress short-term profitability as an industry-wide operating objective to bolster sagging capital positions. The industry obliged, turning its

attention to those investments that generated the highest up-front fees and the highest potential profits. Unfortunately, the increased credit risks that accompanied these assets caused a second wave to the crisis in the mid-1980's.

The regulatory process is now catching up to the problems through such means as increased resources, expanded training programs, improved Federal-State cooperation and increased levels of experience and expertise in both examination and supervision activities. These advances have been supplemented by a renewed regulatory emphasis on general safety and soundness within the industry rather than mere compliance with regulations. This accompanies a specific effort to act proactively rather than retroactively in addressing specific regulatory concerns.

RECOMMENDATIONS

Mr. Chairman, ACSSS applauds the resolve of this committee in moving so quickly on this issue by scheduling an early mark-up. We also commend the administration for facing up to the problems of the FSLIC as soon as it did. We are generally supportive of the Administration's bill. We will only comment here on the areas where we feel strongly that the bill should be improved, or as to which we wish to raise what we think are serious questions.

1. The Cost of the Rescue Plan

The Administration's plan calls for approximately $90 billion to be spent, exclusive of financing costs, in resolving the FSLIC insolvency. Over the past several months, a great deal of attention and energy have been devoted to quantifying the size of the financial hole in the industry. It seems every few days a new study comes up with a different, usually higher, estimate of the cost of resolving the thrift problems. A definite figure cannot be calculated because the ultimate cost of resolution will be dependent on the local economies in which a problem institution has its assets, and the volatility of interest rates both regionally and nationally. The cost will therefore be subject to constant changes.

Whatever the actual final cost might be, the resolution of this crisis will undoubtedly require tens of billions of dollars each year over several years. We should commit to funding a multi-year effort on a continuing basis at the highest level that can be absorbed by a rational, well-conceived case-resolution process. The fundamental reality confronting us, however, is that the thrift industry today is not strong enough to generate by itself the large amounts of funding required.

2. Getting to a 6% Capital Level

The Administration proposes a 6% capital level for thrifts by June of 1991. We would suggest that before a 6%, 1991 formula is decided upon, this subcommittee should require the FHLBB to provide detailed and specific information on the number of insolvencies that would directly result, on a year to year basis, from applying those capital requirements. Such information should be readily available from the Bank Board.

A recent and well publicized study by Shearson Lehman Hutton, Inc. concluded that in order to meet the 6% capital requirements of the administration's plan by June 1991, affected thrifts would need to raise $20 to $35 billion in new capital. This compares with the $4.2 billion thrifts were able to raise in the 1987 - 1988 period, and the $20 billion they raised from 1980 to 1988. Most of that capital was raised in the process of conversions from mutual to stock ownership, and at a time when there was much less disincentive to invest in the thrift industry than there is today.

Even if one focuses only on the still solvent but undercapitalized thrifts (GAAP capital greater than 1.5% but less than 6%), additional capital of $12 to $20 billion would be required to meet the 6% 1991 target, according to a recent study by Ferguson & Company.

This subcommittee should consider, depending on the information we suggested it should request from the Bank Board, whether the phase in period should be longer than the June 1991 date in the Administration's plan.

While we agree that the industry should contribute as much as it possibly can to the resolution of this crisis and toward preventing its recurrence, we must caution against setting inflexible capital standards without taking concurrent action to facilitate capital formation. Otherwise we will surely increase the number of insolvencies. There is a basic inconsistency between requiring that thrifts raise substantial capital by June of 1991, on the one hand, and limiting their ability to merge with, acquire or be acquired by banks on the other. ACSSS also believes that the question of changes of forms of ownership (e.g., mutual holding companies) should be considered in this regard as should the questioning of phasing out good will. If our major focus is to raise capital ratios, then such disincentives to capital formation should be more aggressively addressed.

3. The Need for a Separately Regulated Thrift Industry

The United States is the best housed nation in the world. No other nation has matched ours in providing opportunities for individual homeownership. This opportunity can be directly attributed to the existence of the savings and loan industry.

The existence of the savings and loan industry is itself a function of the governmental enforcement of a regulatory policy which requires "qualified thrift lenders" (QTL) to offer a significant portion (60%) of their assets to U.S. consumers in the form of housing related loans. At the end of June, 1988, mortgage loans and mortgage-backed securities held by savings and loans represented 43% of the total mortgage debt outstanding on one-to-four family homes. On the other hand, commercial banks held less than 20% of the total market.

Commercial banks are not subject to a QTL requirement and there is no reason to expect their 20% commitment to housing will grow or even remain static as macro-economic and regional conditions continue to affect the housing market. Since no industry other than the thrift industry is governed by a government-enforced housing policy, removal of the "qualified thrift lender" requirement will result in substantial needs of the mortgage market being ignored.

Some people have assumed that the mortgage banking industry can fill any such void and become the predominate, if not exclusive, provider of mortgage funds in America. But mortgage bankers, who are funded wholely through the resources of the secondary market (GNMA, FHLMC, FNMA) are subject to most of the same systemic market problems that S&Ls presently face, (poor underwriting, market area depression, volume sensitivity to interest rate fluctuations). If the secondary mortgage market is somehow made responsible for the housing industry in the U.S., the availability of credit to the American homeowner will be left to the mercies of Wall Street. Moreover, if the United States Congress should ever face the prospect of the multiple failing of such federal securities, the potential damage to the economy would be significantly more severe than the failure of a certain percentage of a single type of financial institution such as banks or savings and loans.

Whether the QTL standard should be raised to 70% as has recently been suggested, Mr. Chairman, is a question involving mostly public perception implications. ACSSS would certainly not oppose some increase in the level of housing related investment needed to meet QTL standards, but we would observe that the 60% level has worked well, and it is difficult to find any evidence that the level of housing investment required by the QTL test is in any way related to any of the thrift industry's problems. Moreover, we would be wary of requiring the industry to become too specialized.

4. Enhancing the Dual Banking System

Mr. Chairman, ACSSS has a special responsibility to point out the irreplaceable contributions our nation's unique dual banking system has made, and will continue to make, to users and providers of financial services. We are convinced that our nation's dual banking system can continue to provide prudent innovation and responsible experimentation in a manner that is consistent with state and federal responsibility for the safety and soundness of the industry and the deposit insurance funds. Our dual banking system has served this nation well for more than 100 years. It would be tragic if the current crisis were used as an excuse to deny states their historic right to respond to the special needs of their local economies and consumer interests.

The inherent tension between state and federal chartering and supervisory functions is healthy. It reflects the fundamental underpinnings of our national political system of checks and balances. Over the years, it has produced state-initiated experiments that have resulted in consumer benefits such as deposit accounts, branch banking, interest bearing checking accounts, and many other innovations we today take for granted. It is hard to see how these beneficial changes would have come about or how future innovations might be developed if we totally preempt the state regulatory and supervisory functions and thereby fully concentrate the control of banking in Washington, D.C.

We support the intent of the Administration's bill to set minimum standards of safety and soundness that will serve to protect the BIF and the SAIF from unacceptable risks to the insurance funds. We would suggest, however, that those standards be structured so as to preserve the discretion on the part of states to meet the differing, and sometimes unique, natures of their local and regional economic realities.

With that in mind, Mr. Chairman, we would suggest the following changes be made in Title II, Section 218 of the administration's bill. Section 218, [5] requires that investments in and loans to a new subsidiary conducting activities not permitted to a national bank, or to an existing subsidiary conducting new activities not permitted to a national bank, be excluded from an institution's capital. ACSSS has no objection to the section as it is written, but we would strongly suggest that consultation with state regulators and a phase-in period be mandated if existing activity is not intended to be grandfathered. Consultation with states and a phase-in would be most important in cases where the activity in question is a profitable and needed service, and/or if exclusion of the investment of capital would lead to insolvency.

Section 218 [V] also gives the FDIC the authority to order that no SAIF state-chartered member may engage in an activity determined to be a threat to the insurance fund. We would suggest adding a legislative requirement that the finding of a threat to the SAIF be made pursuant to some established guidelines; that the state consultative role and a state's ability to comment, as now provided in the bill, be more specifically defined and protected; and that some formal appeal process be permitted in order to protect states from the possibility of an arbitrary or capricious determination.

5. Regulatory & Structural Changes

ACSSS strongly supports the separation of the insurance function from the FHLBS as suggested in the administration's bill. This is perhaps the single most necessary and important structural change this subcommittee could implement.

However, the administration's bill, while seeming to contemplate a structural relationship resembling that between the FDIC and the Comptroller of the Currency, unnecessarily dissipates and overlaps authority among too many regulators.

We would suggest that the FHLBS be given chartering and regulatory supervision over federal thrifts and that the state thrifts be regulated by state regulators who are nationally certified pursuant to a system such as was recommended in the 1984 report of the Task Group on Regulation of Financial Services, chaired by then Vice President Bush. A certification system for state regulators has been successfully implemented by the FDIC in cooperation with state bank regulators. The productive relationship resulting from this cooperation demonstrates its feasibility.

Like the Comptroller of the Currency does with national banks, the FHLBS would charter, examine and regulate federal savings and loans. The FDIC would examine state savings and loans in cooperation with certified state regulators, just as in does now for state banks.

Such a system would provide clearer lines of authority, avoid costly and confusing duplication, make better use of existing resources and promote greater efficiencies. Absent such a system, state chartered thrifts and their subsidiaries would be subject to overlapping, expensive and duplicate examinations by three distinct regulators.

Whatever system is ultimately adopted, regulatory officials to be effective must have a high degree of discretion to apply the various carrots and sticks available for use. All financial institutions are different, even those with similar statistical profiles, and therefore require differing regulatory strategies and tolerances.

In nearly all instances, those who are closest to the problems -- be they federal or state regulators -- are in the best position to document, analyze, and quickly respond to unique local circumstances. ACSSS believes it is this ability to understand and address unique local problems that is the overriding strength of the state charter system. Unfortunately, over the past several years, this strength has been compromised as S&L regulatory decision-making slowed under the burden of an increasingly cumbersome federal process. We believe that Congress must be willing to recognize the need for state and federal regulators to exercise significant discretion in their regulatory duties. In the case of the state-chartered segment of the industry, the dual regulatory structure offers a natural set of checks and balances that maximize usage of our state regulatory and supervisory resource. A national certification process for state regulatory programs should proceed expeditiously. Once states are certified, their examinations of institutions (at least of those with a MACRO rating of 1 or 2) should be accepted at the Federal level.

ACSSS has been working to develop such a system for national certification of state examiners.

6. The State Regulatory System

The state savings and loan system is alive and doing very well. Although the performance of state-chartered savings and loan institutions in four or five states has been extremely poor, federally chartered institutions have also performed badly in those states.

Mr. Chairman, ACSSS is not here to defend the excesses of state legislators and state regulators where they have occurred. There have been bad decisions made by some legislators, and bad regulation by some regulators. But, that is as true of the federal system as it is of the state system. People who vilify the state system are only looking at a small part of the picture and are ignoring some glaring success stories.

For instance, the state of Wisconsin has a very strong Savings and Loan system. Over 70% of their S&L industry is state chartered and has a GAAP net worth of nearly 8%. On the other hand, federal S&L institutions in Wisconsin have a RAAP net worth of only 5%. (Presumably somewhat less than 5% on a GAAP basis.) The reasons for this are that unlike their federal counterparts, Wisconsin state regulators have not permitted RAAP accounting, and they allowed S&L institutions to put escalator clauses into their mortgage contracts at a time such clauses were forbidden by federal regulators.

There are many other examples across the country which demonstrate the value of a system that allows states to be innovative, but they go largely ignored by those who seek to make scapegoats of the states.

State regulators have often been frustrated when dealing with the FHLBB. In the early and mid-1980's, we frequently would close insolvent state institutions, only to see them immediately reopen -- still insolvent -- under new federal charters. By refusing to close hopelessly insolvent institutions, the Bank Board only postponed, at great expense, the inevitable.

In the early 1980's, as the magnitude of the thrift problems began to become apparent, the instinctive reaction of federal regulators was to close ranks and consolidate primary regulatory authority within their own structure and procedures. As this authority was consolidated and centralized in Washington, local regulators -- state and federal alike -- became increasingly frustrated as the Bank Board demanded that key regulatory decisions become part of a centralized clearing process to assure nationwide uniformity of application. Unfortunately, this was exactly opposite of what was needed. At a time when key decisions should have been made quickly in the field by a state/federal regulatory partnership, the Bank Board refused to delegate such authority.

As a new regulatory structure is developed, it is important that state regulators' authority be both recognized and encouraged. Financial institutions generally rely on the support of state and local communities for their existence, and have enjoyed a generally good relationship with those communities for decades. Given this relationship, the states have a legitimate interest in the operations of these institutions that must be recognized by the federal government.

Mr. Chairman, we at ACSSS believe it is not only legitimate but obviously desirable for the federal government to seek to eliminate serious risks from state institutions to the federal insurance system. The state system can and should operate within a structure of reasonable constraints upon activities that are a threat to the insurance funds. However, such constraints need not and should not be stifling. Both the federal and state governments want to preserve a safe, sound, profitable industry that serves the needs of the community and there are reasonable ways (such as risk based capital requirements) to accommodate both state interests and the integrity of federal insurance.

Many states have granted expanded operating authority to state-chartered thrifts with very positive results. The current strength and profitability of state-chartered thrifts in several states -- Wisconsin, Ohio, North Carolina, and Illinois among them -- bear witness to the advantage of judicious use of available investment authority.

7. Section 302 of the Administration's Bill

Finally, Mr. Chairman, I would like to call your attention to a provision in Title III [302] (al) of the administration's bill that attempts to prohibit a savings association from making loans beyond one hundred miles of its principle office except those specifically permitted by regulation of the FHLBS. This provision creates at least two serious problems that could devastate the thrift industry.

1. It would effectively prevent savings and loans from participating in loans originated by other institutions, a common practice that the bill eliminates at an unacceptable risk.
2. It would prevent state-wide branching, a growing trend

in the various states, by preventing thrifts from making loans at the source of their deposits. Such loans are required by the Community Reinvestment Act, a violation of which would presumably prevent the branch from operating.

Mr. Chairman and distinguished members of the committee, we at the American Council of State Savings Supervisors want to work with you and your committee in honestly confronting and resolving this most serious crisis. Our members are uniquely qualified and prepared to cooperate with the Congress in this critical process. As an association, we have dedicated ourselves to promoting a better trained and skilled cadre of state regulators; nationally certified state regulatory and supervisory standards; more uniform and professional appraisal standards; better education of regulators in general; and closer cooperation between state and national regulators.

Thank you again for this opportunity to testify before you.

The CHAIRMAN. Senator Bryan, did you have an opening comment you wished to make?

Senator BRYAN. Mr. Chairman, I do not. I will reserve time for questions.

The CHAIRMAN. Very good.

Let me now ask you this question. I appreciate what you say. We all bring a point of view, and we all bring an interest to the table. You folks are in the business of State regulation. You're State regulators. You do a very good job, and you obviously have confidence in your system and in your own procedures and your individual records would bear that out.

But I want to pose this question to you and I'd like you to step out of your role now for a minute and try to think about this just as a citizen, just as somebody looking at the problem.

We've had a failure in the savings and loan system that's going to cost this country at least $100 billion—at least $100 billion. It's a lot of money. We've had no financial catastrophe on this order that we've had to deal with before. It's just off the charts in terms of any kind of comparisons that we can make.

And the Federal taxpayer, under the Federal insurance system, is now being asked to pay for most of this problem, a problem that they really had no direct involvement in or connection to or hand in causing, but nevertheless they are being asked now to come in and pick up the tab.

If States want to add additional powers to a Federal savings and loan charter, maybe sensible ones, maybe in some cases not so sensible, but ones that may have a different risk profile, why shouldn't the States themselves accept the responsibility for insuring those additional activities if they want to provide those powers?

If you want to take the authority to do it, why don't you accept the responsibility for being willing to insure it?

I'd like to hear both of you respond to that.

STATE REGULATION AND RESPONSIBILITY

Mr. SEYMOUR. That's fine, Mr. Chairman. I think it's an excellent question. It goes to the heart of where the crisis is today and it really addresses the issue of how are we not going to get back into this problem again.

I have, as I said, and ACSSS has no difficulty whatsoever with, if I can restate your premise, the Federal insurer simply having the authority to determine what it wants and what it does not want to insure. I think that's a sound statement and it's supportable.

What I really have in the way of an answer, though, is what concerns me is the process. If we simply approach it as an issue that whatever has been permitted under the chartering authority to Federal institutions is therefore safe and sound and that which is not permitted to Federal institutions is not safe and sound, I think you have government stagnating new market innovations.

What I would like to see, and I believe I speak for most of the regulators in ACSSS, is a process by which the States can propose new ideas, new opportunities, have hearings held within the insurer and have the safety and soundness of that product solely addressed—all right. In that kind of an environment, if the insurer determines that one of two things—either it is an unsafe or unsound product or if it's going to permit the activity that the cost of insurance is going to be higher—then the State has an ability to respond—or an institution has the ability to respond with that situation.

However, if there is a determination that the product is not safe and sound, then you're quite right. I believe that the State has then its own decision to make, whether it wishes to provide insurance to back up that power authority or it simply does not wish to permit that activity to the savings and loans.

The CHAIRMAN. Mr. Kuthy, let me hear your answer and then I want to respond myself.

Mr. KUTHY. Clearly, the question you asked is——

The CHAIRMAN. And if I may, let me just try to sharpen it again. I appreciate your answer, but it was a little what I would consider indirect. That is, if the State wants to have the authority to add additional powers that are State granted powers, why doesn't the State in turn accept the responsibility directly for insuring those additional activities rather than asking the Federal Government to do it?

Mr. KUTHY. First of all, the question you pose is somewhat analogous to the dilemma of siring children and then raising them, and that question is ancient.

The second level of answer to that goes to the question of whether or not this issue has been before the Congress, and it was back in the 1930's when Federal deposit insurance was proposed initially. The concept at that time was argued that many States had deposit insurance across the years but because the problem is larger than most States have the capability of handling it was a logical thing for the Federal Government to assume this role.

However, in answer to your question about whether a State should do this or not, we've already had some examples of failed opportunities in this area, both in Ohio and in Maryland, because private insurance or State-sponsored insurance simply doesn't work for almost all the reasons predicted in the discussions in the 1930's.

The CHAIRMAN. Well, I don't think you can leave out now the third example, and that is that Federal deposit insurance didn't work either. We now have 2 State catastrophes to look at, Ohio and Maryland, and you now have a Federal catastrophe to look at that's on a systemwide basis where the numbers dwarf what we saw in Ohio and Maryland.

Mr. KUTHY. You're absolutely correct.

The CHAIRMAN. Why couldn't we solve the problem this way: If the States want to add additional operating authority to the savings and loans and you don't want to provide the insurance, you don't want to take on that burden and you say you've got examples of where that hasn't worked properly—I've got a very big example where it didn't work either at the Federal level—why not require that those go in a separate affiliate under a holding company arrangement, a separate affiliate with firewalls between the things that are in the Federal charter and insured by Federal insurance, and then separate off those other activities, allow the savings and loan to do it, but not on the foundation of Federal deposit insurance? It seems to me there's an inherent contradiction when you say, look, don't ask us to insure these additional powers because we see carcasses on the landscape of other States that tried and failed. We would like you to do it and then if the system is blown out of the water and you've got a huge bill to pay, well, that's just the way it is. But we'd like you to continue in that area to provide the insurance for our State granted powers.

Why not just separate that and not provide Federal deposit insurance for that? If you want to continue to let the savings and loans in Michigan or in Ohio or Illinois do this, do it in a separate affiliate. What's wrong with the separate affiliate idea?

Mr. KUTHY. We have no quarrel with the notion of a separate affiliate.

The CHAIRMAN. Without Federal deposit insurance under the affiliate?

Mr. KUTHY. Absolutely.

The CHAIRMAN. How about you, Mr. Seymour?

Mr. SEYMOUR. Well, I have no difficulties with the form, Mr. Chairman, but I do in some sense have to keep coming back to your premise, which is difficult for me to accept, and that is simply because it's not permitted to a Federal institution that it is inherently unsafe and unsound.

Let us remember that it was Garn-St Germain that permitted 40 percent of assets of Federal institutions to go into commercial real estate activities. And if you want to look at the Texas problem, it goes directly to that kind of a power authorized to Federal savings and loans.

All I'm trying to come back with is on your premise— if I'm given first the process, the opportunity to present a new power and service from the States to the insurance company and have a fair and open hearing on it, after that, then I think your answer is on target. If it's determined to be unsafe and unsound by the insurer, then the State has a decision and the decision probably should be a subsidiary activity.

The CHAIRMAN. Earlier in your testimony Mr. Kuthy, you said that in looking at the system's failure the regulators themselves are part of the breakdown. I have to tell you that in writing this legislation I want to have enough safeguards built in so that I, in a sense, anticipate the possibility of a faulty regulatory system. I want to anticipate the possibility of other sort of regional economic problems that are of an engulfing sort that can pull the whole system down.

We have a chance to learn from this disaster how to prevent the same kind of a disaster, but we also have the opportunity to think a little further than that, to think about how else equivalent size disasters might come in a somewhat different direction.

If we only solve today's problem without using the opportunity to anticipate how this problem might come out at some other time, I think we make a giant mistake. I think the time has come to disconnect Federal deposit insurance from what States may wish to add. I don't fault the notion of the States having the need and the value in doing some experimentation and that they be laboratories for trying out new things. But if you don't want to accept the responsibility yourself for insuring those add-ons—and I don't hear much appetite for that—then at a minimum, I think they have to be separated from Federal deposit insurance and put in a separate affiliate under a holding company with firewalls in between, so that the Federal taxpayer doesn't wake up some day and find out all of a sudden they've been hit with another $60 or $70 or $80 billion charge because the insurance system went haywire.

Mr. KUTHY. The Federal taxpayer is also the Michigan taxpayer and shares that same feeling. The nexus of the discussion is not the presence or absence of insurance for a State power. It's the question of the process that's used by the Federal Government in evaluating that State power because it's just as much in the interest of the Federal Government to promote the innovation and development of the financial system that has been characteristic of the States for decades and decades. And it's that balance that we seek and it's the process described by Mr. Seymour that suggests that if it's fairly and thoughtfully and systematically done and not exclusively in a knee-jerk reaction that says you must either support this child yourself or not have the child. To us, we think that measure is so utterly Draconian that you lose the benefits of that system.

We are not against at all an evaluation being made of either a federally issued power or a State issued power. What we would prefer to see is a very elaborate, very thoughtful, analytic system that makes that decision before we bet the taxpayers' money or the FDIC's insurance fund.

The CHAIRMAN. I want to yield to Senator Heinz. I understand you both to say that you could live with a system where the State powers were put in a separate affiliate under a holding company arrangement with firewalls and without Federal deposit insurance. Is that right or wrong? I'm not saying that you would prefer that. I'm saying that you could live with that kind of arrangement.

Mr. SEYMOUR. Such a system? Yes, as long as the process—and I have to constantly add that in—as long as there's an open and fair process to determine what goes in that subsidiary.

The CHAIRMAN. And do you agree with that, Mr. Kuthy?

Mr. KUTHY. The same way that Mr. Seymour has put it, the notion is not the presence or absence; it's the method by which we make that determination that's really quite important.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

I want to ask a question about the 1991 capital deadline. According to Mr. Seymour's testimony, we should consider extension of that deadline beyond June 1991.

However—and I'm sure you will agree—most people feel that one of the reasons for today's thrift problems is that little or none of the thrifts' own capital was at risk. As a result, they gambled with insured deposits and not their own money in trying in many cases to grow their way out of problems and, as we know, grew their way into the taxpayers' wallet.

Under the President's plan, a thrift that fails to meet those capital deadlines will simply not be permitted to grow its way into compliance the way the people tried to do in the last 7 or 8 years.

What is wrong with that approach? We don't say they have to be shot, liquidated or otherwise buried. What's wrong with keeping those kind of controls on thrifts that can't meet the capital deadline?

Mr. SEYMOUR. I was with you until the last moment, Senator. The types of controls—and maybe let me answer——

Senator HEINZ. It's the growth control.

CONTROLS ON THRIFTS THAT DON'T MEET THE 1991 DEADLINE

Mr. SEYMOUR. All right. I have no difficulties with that at all. In fact, the watchword of the day—and we use it in Illinois—is that capital is key. You're exactly right. If capital had existed when interest rate differentiation was killing in institutions, the problem would not have been as excessive. If capital had existed in the institutions when Texas occurred, the problem would not have been as excessive.

We in ACSSS have no difficulty whatsoever with the 6-percent capital level. In fact, there's even a conversation of going 8 percent capital level and I think that is a target to shoot for. That's a personal opinion, not ACSSS's.

But the experience in Illinois, we can draw down just on the State charters in Illinois specific facts, and the facts tell us in Illinois—and I'll share it with you here—that right now under the initial RAAP conservatorships that have been required by FSLIC, by contract with FDIC, Illinois State chartered had one institution that went into that conservatorship. If the 6-percent cap provision is held on a 2-year period, we will have ten institutions that, based on previous performance history, will not be able to meet that 6-percent cap. Five of those ten institutions, Senator, today are making money quarter to quarter. Their gain in capital is positive, not negative.

All that we are asking for from ACSSS is—with that information we were capable of doing that in Illinois in 5 hours with a computer run on 97 institutions. It is available. We are simply asking that expeditiously you should have that information in front of you because extrapolating from our experience says that with the 6-percent cap going in in 2 years, 10 out of 97 institutions will not be able to make it and we in Illinois have 6-percent net worth across the board, and we're in a very good situation in Illinois. I suspect the damage—you should at least know what it is.

Senator HEINZ. I think you're quite right and I trust we will get that comprehensive information. So far, as you know, even the League and the S&L representatives were unable to provide it, at least up to this point.

My question also goes to this. Let's take a worst case assumption that it's not 10 of your 97 that end up in this situation, it's 50 of your 97, not that I wish that on you. But what happens?

Mr. SEYMOUR. For the record, it's not possible.

Senator HEINZ. What happens to any one of those hypothetical 50? Is having a limit on their deposit growth a Draconian kind of precaution?

Mr. SEYMOUR. No. And if I can, I think what happens there is you're forcing institutions in savings and loans into addressing the issue of economy of scale. Failing any other opportunity that is marketplace development of capital, they will have to seek it from outside sources, and the options available to them to seek capital from outside sources—if you're a mutual institution you can do a conversion and sell in the stock market if that's possible. The second option is outright acquisition. You get someone to buy you and bring the capital in. The third option, which I hope is one you will consider, is the one we've implemented in Illinois called a mutual holding company structure in which you're capable of selling off parts of your net value and gaining capital from that form.

But all of them speak to the same thing. The industry finding an appropriate economy of scale, which banks have just been through.

Senator HEINZ. But my question is, if our position is that you can't grow until you've got the dough, what is wrong with that?

Mr. SEYMOUR. I see nothing wrong with that. I'm sorry.

Senator HEINZ. I may have misinterpreted your testimony, that there was something wrong with the 1991 capital deadline.

Mr. SEYMOUR. OK. The 1991 goes to 6 percent of capital, which is the ownership value of the institution. If an institution can grow fast in capital, we have no particular difficulty with that. The nongrowth provision generally goes to the issue of taking in deposits.

Senator HEINZ. I understand that.

Mr. SEYMOUR. And that's not real capital. That's a liability on the books.

Senator HEINZ. I understand. If the chairman will permit me, just to clear up some confusion here, my question is, if an institution hasn't met the 6-percent capital requirement by 1991, what is wrong with having the no-growth precaution on deposits now—on deposits, not on capital—we want the capital to grow, as a safeguard against history repeating itself?

Mr. SEYMOUR. We see no difficulty with that at all, none at all.

Mr. KUTHY. I support that totally and that's the steps we've taken in Michigan and that's why we only have three State chartered S&L left.

Senator HEINZ. Now my conclusion on that is that you both support the 1991 6-percent capital requirement.

Mr. KUTHY. Yes.

Mr. SEYMOUR. Yes, and I would say in a limited sense we support the 6-percent capital requirement. I would reserve 1991 to seeing the specific impact on the industry.

Senator HEINZ. And your fear there is what?

Mr. SEYMOUR. My fear there that the number of institutions supervisorially that we would have to deal with because of choosing the date 1991 might be beyond both of our capacities to deal with.

Senator HEINZ. I see. That's very helpful. You're saying if that implies intensive or increased supervision as opposed to just a rule that says you fellows can't go out and just call up your friendly deposit broker and take as much in and lend as much out as you possibly can, if it goes beyond those kind of rules and gets people-intensive, then you would worry?

Mr. KUTHY. I would disagree with Mr. Seymour to this extent, that the measures necessary to institute a policy that achieves 6 percent capital by the target date must be a regulatory concern and must be initiated immediately after the passage of the bill.

Senator HEINZ. Thank you very much. My time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

In my State of Alabama, I understand there's only one State chartered institution, and listen to this—this thrift has 12 percent capital. It hasn't cost the FSLIC one dime.

Now I know that's not the rule. A lot of people are concerned with the dual banking system and so forth.

Let me pose this to you. Should the Federal regulator have the authority to limit State activities where those activities demonstrably expose the system to potential liability? You see what I'm getting at. In other words, should you be able to say no as a Federal regulator if the Federal regulators are seeing what the State chartered institution is doing that in his wisdom can be very dangerous to the system? You want to comment on that?

Mr. KUTHY. Yes, sir. If you're using the term Federal regulator generically to include all Federal regulators, I would say no. If the Federal regulator is the Federal insurer, I would say yes.

Senator SHELBY. Because of the risk to the system?

Mr. KUTHY. Yes, sir.

Senator SHELBY. You both agree?

Mr. SEYMOUR. I absolutely agree, Senator.

CONTINUATION OF DUAL BANKING SYSTEM FOR THRIFTS

Senator SHELBY. Should we continue a dual banking system in the thrift industry because some of the States have lenient areas maybe the thrifts could get into and maybe this is like a lab to see how some things work? I don't know. I'm just throwing that out.

Mr. SEYMOUR. I think one of the greatest and probably the single best result of the dual chartering system, whether that's savings and loans, banks or credit unions, is that innovation generally historically has come out of the State system, not out of the Federal system. Almost without exception that is the case. And those innovations are not risky new activities, Senator. Those innovations have been solid products that consumers have wanted.

The statement that, without getting terribly Jeffersonian here, but quite frankly, the closer an institution is to the marketplace, the more likely they are to come up with that product which is going to respond to marketplace need. State regulators are simply closer to the marketplace it seems to me. That's a personal impression.

Senator SHELBY. Why?

Mr. SEYMOUR. Because we are interested in local marketplaces. We look at the Midwestern marketplace as the State of Illinois much better than the Federal Home Loan Bank System could look at the market needs of that area.

Senator SHELBY. Do you think they're just too remote from the people or to the ideas of the markets?

Mr. KUTHY. Both. If you had a complaint, for example, against a State chartered bank or a State S&L or a federally chartered bank or a federally chartered S&L, who are you going to call? The guy in Chicago long distance at your expense or the local bank regulator? That really is part of the rhetorical answer.

The other part is quite clear, that in each of our States our local governments are tuned to our local economic conditions. The wonderful, at times, almost indifference on the part of a Federal regulator to any individual State is both a market good quality and at the same time that level of indifference doesn't meet the consumer needs of that particular area. The region or nationally, that's a different issue.

Senator SHELBY. How many State chartered institutions do you have operating today in the United States? Just roughly.

Mr. SEYMOUR. I'm going to have to do a quick estimate.

Senator SHELBY. Just a judgment call.

Mr. SEYMOUR. All right. There are 3,000 institutions nationwide. Let me find out for you because I'm going to be guessing in the air if I don't.

Senator SHELBY. A third of them or less?

Mr. KUTHY. If you're talking State chartered banks, there are almost 15,000 and about two-thirds of them, just a little under 10,000, are State chartered. And over 50 percent of the assets of the banking system nationally are in State chartered banks.

Senator SHELBY. How many State chartered thrifts?

Mr. SEYMOUR. Slightly under half of the 3,000.

Senator SHELBY. About 1,200 or 1,300?

Mr. SEYMOUR. Yes.

Senator SHELBY. How many of the State chartered thrifts are insolvent today percentagewise as opposed to the federally chartered thrifts? Do you have a number on that?

Mr. SEYMOUR. I do. 16.95 percent of Federal charters are GAAP insolvent. 15.04 percent of State charters are GAAP insolvent.

Senator SHELBY. So you're close then?

Mr. SEYMOUR. They're comparable. Then the other figure is Federal average GAAP net worth is about 2.25 percent; State average GAAP net worth is about 2.47 percent. So it's comparable.

Senator SHELBY. I don't want to brag about the one in my State of Alabama. We had five to go under down there already. But when a State chartered institution, the only one in any State, whether it's Alabama, Michigan or Illinois, has 12 percent of capital and is operating, I think they're doing something right, aren't they?

Mr. SEYMOUR. They're doing something right, Senator.

Senator SHELBY. And it wouldn't matter whether they were Federal or State chartered.

Mr. SEYMOUR. Absolutely not.

Senator SHELBY. Ok. Mr. Chairman, thank you.

The CHAIRMAN. I don't want the Senator from Alabama to think I didn't hear about that case and I'll be back to talk about that in a minute. Senator Bryan.

Senator BRYAN. Thank you, Mr. Chairman.

Mr. Seymour, you in response to Senator Shelby's question gave a number of institutions, State chartered vis-a-vis Federal institution, that are insolvent. I want to reframe the question not in terms of numbers, but if one takes a look at the total dollar amount—not the institutions—what percentage is in federally chartered and what percentage is in State chartered?

Mr. SEYMOUR. I can get that figure but quite frankly I'm not prepared to give that now.

Senator BRYAN. Would your horseback estimate be that the dollar figures would track the institution numbers or would you suggest that the dollar amount of the problem is to a much greater extent occasioned by problems in the State chartered thrifts?

Mr. SEYMOUR. Again, I honestly don't know. I can find out. The one response I would have on it, though, in terms of asset risk, I'm not sure what even good that indicator is. Bad management in a large institution will cause assets to be insolvent on a larger base, but that's one management and one institution.

I would also add into any equation in insolvent institutions, my experience is it's about 50-50, 50 percent of the institutions are insolvent because of economic forces circumstances and 50 percent are there flat out because they would be there anyway.

Senator BRYAN. Let me follow up on the line of questioning that you and Senator Heinz were pursuing. That is the 1991 capital requirement.

The thrifts have been in here and indicated that they need not 2 years but 5 years to achieve that. You seem to say in your testimony that you're satisfied with 1991 assuming that existing institutions are grandfathered in in terms of their capital requirements. At least that's what your testimony seems to suggest.

If we grandfather that in, what effect does the 1991 rule have?

Mr. SEYMOUR. For clarification, Senator, what I was talking about in the way of considering grandfathering for the moment and phase-out was on several issues. On that point I was talking about those subsidiary activities which are being asked to be forced down into subsidiaries—or that activities being asked to be forced down into subsidiaries. I would hate to see a quick fix situation where individuals are asked to sell profitable companies in the marketplace under a forced situation and take losses because there's an arbitrary 1991 deadline. I would not suggest that we grandfather any institution at the moment on the 6 percent capital. We need a target date absolutely for 6 percent capital. We absolutely do need that date. But whether it's 1991 or 1993 really should come out of the objective evaluation of its impact on individual institutions which you can get.

Senator BRYAN. I think the skepticism or the reluctance of some of us, we want to provide enough flexibility that we don't create a greater problem than we already have by in effect forcing savings and loans that could make with prudent management, with some flexibility, into an insolvent condition, and yet balancing on the opposite side of the argument is that there is an inherent distrust that I have and I think other members of this committee have, is the incestuous relationship that's existed between the regulators and the industry. What assurance, if we give some flexibility, are we not going to have the same kind of games played which in my judgment is a major contributing factor in the problem that we face. Can you give me any assurance? Can you suggest some benchmark provisions that we can build into the law to give the flexibility that the thrift industry argues for, and yet at the same time we don't dance around this issue and come back in 1992 and say, well, yes, I guess we gave them too much flexibility. There's got to be something to assure at least some of us on this committee that we're not going to give so much flexibility that apparently these smooth-talking folks are able to persuade the regulators to go along with most anything.

Mr. KUTHY. Well, I think I can talk for the 35 or 36 States that have integrated financial institutions regulatory authority where all depositories are under one State regulatory agency such as my own.

In those instances, having a situation of one depository industry with a set of capital standards that are meaningless, as they are under the present Federal system, or having it as sensible and prudential as it has been under the banking system, doesn't make any sense. Having a 6-percent requirement in 1991 is flexible enough, in my opinion, and I think in the opinion of most of my colleagues. There may be differences of thought on that about how fast you achieve it, but regulatory resolve and a dedicated thrust in that direction, which means no growth unless it's financed by earnings, under GAAP accounting, with an adequate capital base, is the only sensible way to put the first line of defense up before we have to think about taxpayer dollars ever again.

Mr. SEYMOUR. To quickly answer, Senator, I think you've already done it in this bill. To me, the ultimate—if there was significant damage because of an interrelationship between the regulator and the industry was to be found in the form and structure of the Federal Home Loan Bank Board System where you had a three-member board that counted— because they were filling out unexpired terms—counted their terms in matters of months, where you had a situation where the insurance company was combined under the same authority as the chartering agency.

Senator BRYAN. I think we all agree that ought to be changed.

Mr. SEYMOUR. That I think was the source of the problem, and I think you have already solved that. That is to me and to ACCESS the single strongest part of this bill, is the removal of the insurance company.

Senator BRYAN. You may have testified on this and if you did I'll stand by your answer in the record. What is your comment with respect to the administration's proposal to wrap this in under the Treasury? Do you agree or disagree with that?

Mr. SEYMOUR. I think the answer to that question really goes to the uniqueness of the industry which requires that whatever its supervision is it has a commitment to housing in America. If there's a satisfaction that Treasury can provide the commitment at the level that's necessary for the regulation of this industry, then it should go to Treasury. If there's doubt of that, then it should not be there.

Senator BRYAN. I take it by the way you're framing your response that at least you may be among those that are not totally persuaded. Would that be a fair comment?

Mr. SEYMOUR. I'll leave you to draw your own conclusion.

Senator BRYAN. I think you've provided it and I appreciate your response, Mr. Seymour.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bryan.

Senator Shelby, I may have said this prior to the time you came in but it relates to the illustration that you cited. I'm very sensitive to trying to reason through the question of how we structure this system in a balanced way to fit all the circumstances. I've asked that some data be generated and let me share with you and Senator Bryan what we have been able to develop in terms of the pattern of failures of State chartered thrifts versus federally chartered thrifts.

There's one other angle to it. When the FSLIC goes in to take over a sick thrift, it normally converts it to a Federal charter. So when you start looking at the data, you have to find out what it was before that step often happened. Otherwise, it would give you exactly the wrong picture.

Here are some aggregate statistics. Since 1983, more State chartered failed thrifts have needed assistance than have federally chartered thrifts, but let me give you the amounts.

Since 1983, a 6-year period, we spent $28.7 billion in assistance to State chartered thrifts. Over the same period of time, we spent $10.7 billion for Federal thrifts.

Senator SHELBY. It's a big difference.

The CHAIRMAN. It is a big difference. Now that may or may not prove the point that I've been concerned about, but there clearly is a very sharp difference.

Let me give you another statistic. We all know that the major part of this problem is in two States, Texas and California, Texas being roughly half the problem in the last several years here in terms of total dollar impact. They also are the States with the most liberal charters, where they've gone the furthest in giving their State S&L's additional add-on activities to what is in the Federal charter.

Those two States have accounted for over ¾ of the assistance given to State thrifts just during the past 2 years and over half of all the assistance given to all thrifts.

Now trying to reason this thing through logically, you could say to yourself, well, does that necessarily follow, however, that it was the excessive State powers that helped sink those systems and helped pull down the whole system.

By itself, I don't know that it would be possible logically to say that that was the straw that broke the camel's back, but it seems that in terms of setting the system up for failure that that dimension, in addition with the other events that then came in, created a system that was just not strong enough to take the total effect of what was brought down upon it and in effect the system collapsed.

Now the regulation wasn't sufficient. The accounting rules weren't sufficient. There were a lot of other elements here. But I think you can begin to reason your way to the point of saying that if those States had not been so far out on a limb with other activities, that when these other events came into the picture, they would not have created the level of catastrophic failure that has now threatened the entire system.

It's so interesting, as Mr. Kuthy knows, that we have Michigan savings and loans that come to see him and come to see me and they say, look, we're in fine shape; we haven't done anything wrong; our capital is strong; we didn't go way afield in our activities. Why should we now find our businesses put in jeopardy or saddled with the restrictive provisions in the future that really inhibit our ability to be successful in the future because of failures somewhere else in the system?

Well, I think that's a fair question, but I think it requires us as we redesign the system to try to design it in a way where we build in enough strengths and enough stability so that we can take other kinds of adverse circumstances in the future. It may well be, just taking the case of the one State thrift in Alabama—I don't know anything about it other than what you've said today—let's say their capital is 12 percent. They've done a terrific job.

Senator SHELBY. And no good will.

The CHAIRMAN. And no good will. Whatever their formula is, we ought to bottle it and sell it to Texas and California.

But what I'm wondering is, because they've been able to do it under that system, with the State regulation system in Alabama, does that necessarily follow that we can design the system to fit that very exceptional case any more than we can to design it to fit an exceptional case somewhere else?

It may well be that what we can do in a case like that—and I'd like to see the specifics—but presumably, if they're that able to be that successful, that profitable, and build capital up and not even include good will in it, that they could do that just as well with some of those activities if they are thought to be a higher risk activity, even though they may have done them very successfully. They can still do those activities. They can still earn the profit from that. But it wouldn't be connected to Federal deposit insurance.

The concern that I have is not that one that does it right. I'm concerned about the next guy down the track that thinks he can do it as well as this guy and finds he can't. Then, he goes into the tank along with others in a windfall cave in of institutions, and all the sudden you've got a $100 billion exposure. Now somebody can say that can't happen. I'd like to have thought that it couldn't happen. It did happen. That's why we're all here.

So it seems to me that after you've gone through a systems catastrophe of this scale, your test is to not just make sure that you've shored up the system where it capsized before; you've got to think more broadly than that and you've got to come up with additional ways to make sure that you're not susceptible to being capsized from a somewhat different sequence of events hitting you.

I think you can do that without killing the system. I don't want to kill the system. I think it's important to maintain the savings and loan system so that we can maintain those 50 percent of housing mortgage originations that they are doing out across the country.

Senator SHELBY. Mr. Chairman, may I comment?

The CHAIRMAN. Yes, please do.

Senator SHELBY. First of all, I appreciate your statistics there. I don't know what each State has done. All of us know from sitting on this committee and going through a lot of hearings and watching this and studying this, that a lot of the thrift institutions, whether they be Federal or State chartered, a lot of it has been management. I'm sure that each State might have some different rules, but still it goes back to management.

I only pointed out, Mr. Chairman, the one in my State of Alabama was because it was well-run, it's State chartered. I'm sure that you can get a Federal charter one and show the same thing. There are not maybe enough of these. I don't know how many there are, but I believe that it still just goes back to who's running it and the risks they take and maybe the philosophy that they have.

And your pointing out that a $28 billion hit versus a $10 billion hit, that says a lot. But should we just throw the sink out? Let's don't do that yet. Because there are a lot of State chartered institutions that are doing things right. But should we have a hodgepodge of rules? I don't think so. I think, Mr. Chairman, that we're going to have to have some basic standards if we keep a dual banking system that the States have to meet those standards too.

The CHAIRMAN. If I may, I think it's a very important discussion that we're having because it's one of the centerpiece issues that will I think determine whether we are successful with our reconstruction program here.

Another way to think about this is that from our vantage point, as opposed say from the witnesses at the table, we've got 50 States out there. You each represent one each of the 50 States and you're the regulators within your separate States.

When you look at a Federal system and if we've got 50 States out there all of which are different in some degree—I don't know that any two are precisely the same. I would be surprised if there are. There are some wide differences State to State, not only in terms of the ground rules but how well the regulatory system works. I mean in some cases it's much more disciplined. There's a long history of high quality performance, and in other States it's a pretty poor record, for whatever the reasons.

But from a Federal point of view, we now have to take and put Federal deposit insurance underneath all the 50 States, the ones with the very good systems and the ones with the not such good systems, and they are all different. Just in terms of the regulatory burden, it starts with you in your own States and you carry out your responsibilities. But from the Federal point of view in terms of protecting Federal deposit insurance and the Federal taxpayer, the Federal authorities have to be adept enough and quick enough and smart enough and plentiful enough of them to be able to monitor all of these 50 States with each one doing it differently.

Then you have to introduce all kinds of other variables—regional, economic swings that take place, populations declining in some areas, growing in others. You've got all kinds of factors that can pile in on top of this so that you don't have a nice static situation where you're just monitoring 50 things that are different but all experiencing the same conditions.

When I look at the Federal regulatory system over the past few years, I think it hasn't done a very good job. I think it's done a poor job. And I think that's true going right on down for the most part through a lot of the system—not all of it, but a large part of it.

I don't know how many Federal regulators we would have to have to really provide the level of scrutiny that I now feel we have to maintain all the time in these 50 different situations, all of which are subjected to different circumstances at different times. I think the cost of regulation—hiring competent examiners, performing the examinations frequently enough and adequately enough, checking real estate values because many of these portfolios are in projects that values can rise and fall rather quickly and so forth—are enormous. To do that and to be up to date on it would require I think a virtual army of supervisory personnel and to get good ones you've got to pay the dollars that it takes to get them.

If you have a system that requires a lot of policing, then you have to hire a lot of police. You've got to really work the system aggressively.

Much of the discussion is premised on is that we can design a system that has a lot of flexibility but doesn't necessarily face up to the need to in turn have a very heavy level of supervision and all the costs and the hassles and the intervention that go with the supervisory system.

I'm losing confidence in our regulatory capability. I don't aim this at the two of you. But I have to tell you that looking at how well we've done at this last problem, my level of confidence in regulation per se has dropped partly because the job is so complex. Things have changed. Fast buck artists can go out and move things around so fast that even a competent regulator can't always catch up with that until it's pretty late in the game.

That leads me to conclude, I'd like to build into this future structure as many safeguards as I can. Not that you have got a paralyzed system. You don't want that because then you get another set of problems the other way. But I want a system for the future where there's enough uniformity and standardization across the 50 States, especially where Federal deposit insurance applies, so that we can do a better job of surveillance on that system because the system falls within bounds that we understand better and which are more clearcut and uniform.

I think we can do that and still give flexibility for different institutions and different places that tend to concentrate more of their activity in one type of activity rather than another within parameters.

But where I think we start to really get into deep trouble is when in effect we say we're going to have Federal deposit insurance and it's there as a blank check and the States can do basically what they think is necessary to go out here. States don't want to take on the insurance risk because it's a little too dicey. They're rather have the Federal deposit insurance. But the States would like to have the advantage of the flexibility to try this, to try that, and so forth.

So finding the right blend to rein this system in so that we've got safety and soundness. I think you've got to have more structural tightness and uniformity but enough maneuvering room within that so that we still have a viable industry that can be profitable and it can attract capital. I think the States have a responsibility to argue for a tighter system. I would say you're off the hook if you say, look, we'd like to get into other areas and we'll handle the insurance burden, we'll take the risk on. If you were in here asking for that, I would say, boy, that's really stepping up to the plate. You want to do these things, and you're willing to insure for the risk. You figure out how to assign the extra charges and so forth.

But when I hear the States come and say, we'd like to have the flexibility to do it, but by the way don't ask us to pick up the insurance tab, we'd like you to do that. We think we can do it within our separate States, and we think we can get the job done even though we meet in a crisis situation where the job wasn't done.

I don't know that either of you want to make the case for how well the system of regulation worked in the State of Texas, for example. You both represent that State because you represent national organizations, but I would think that you would find it terribly difficult to come in and make a very compelling case for how well the regulatory system worked at the State level in Texas.

FLEXIBILITY IN THE SYSTEM

Mr. KUTHY. It would be like Marcos defending his wife's 3,000 pairs of shoes, Senator. But we're not here to make a case for Texas-style regulation. We are here to make a case for a national system which has been posited in the administration's bill and has a very sensible approach. We would commend to the Senator, with all due respect, that notwithstanding either an inability or experience with deposit insurance at the State level does not make it a sensible proposition. We would still submit that building safeguards into the system as is presently done in this bill that are sensitive to the innovative capabilities of States to offer financial services that are tuned to the consumer needs in those States is an important issue and one that must not be attended to in a wholesale basis.

The FDIC itself some several years ago, after pondering the notion of a real estate direct investment rule, concluded there was no abuse in the State banking system and abandoned such a rule. We would submit to you that that was a sensible proposition because it was a blanket proposition across the States and in fact that problem did not exist.

We would hope that the sensitivity of this new Federal system that's about to be put in place recognizes the dynamism. We would submit that separation of powers and the ability to have checks and balances in ancient and time-honored political concept in this country makes sense in the case of the dual banking system an expression of that same thing.

We would only ask that that dynamic capability be preserved.

The CHAIRMAN. I must say you have a wonderful way with words. Nothing new for you, my friend. But another way to abstract that all the way down is to say that you'd like the authority to be able to do certain activities at the State level, but you really don't want the responsibility to have to do the insuring for those activities.

Mr. KUTHY. That's not correct, Senator.

The CHAIRMAN. I know you don't think that's correct, but I think I can attach that interpretation to what's being said. It seems to me the States in this instance want the advantage of the Federal deposit insurance guarantees and yet they want to be able to do some experimenting on the margin without having to accept the responsibility directly for insuring those other activities. They want to leave that responsibility somewhere else, namely here.

Mr. KUTHY. No, Senator, you're absolutely incorrect. The only point we're talking about is the process by which the decision is being made. The decision to accept or reject any power of the State that's given to a bank or a savings and loan or a credit union ought to be exclusively and solely in the insuring agency, and we are only asking for sensitivity in the method by which the determination is made so that we can preserve to the extent we can those sensible innovative ideas that do not put the system at risk.

The CHAIRMAN. So if this committee decides that it wants to write the charter for a Federal savings and loan institution and have that apply to the 50 States and that's what the insurance will cover and nothing more, you will be quite happy with that?

Mr. KUTHY. That would be far too broad, Senator, because those points, many of them, have been established at the Federal level and have failed miserably. We already have an example.

The CHAIRMAN. Now you're arguing against the very point you made a moment ago. If what you're saying is that you're willing to have that decision made at the Federal level, you want to be able to present your view and get a yes or no vote, and you will live with the consequences because you don't want to take on the insurance responsibility. You want us to carry that, and that's fine, we should carry it, and we will reserve the final right to say what's in or out. What's wrong with that?

Mr. KUTHY. We have no complaint of that.

Mr. SEYMOUR. Again, I hope there is no remaining impression in your mind, Senator, that the States are suggesting that we want to provide powers and services that are uninsurable. That is not what we wish to do. We feel that the insurance company should indeed have the right to determine what it will cover and what it will not cover.

The CHAIRMAN. And if we make the decision now that there are some State powers that should not be insurable, you would be content with the solution of that problem to split those powers up and put those in a separate affiliate under a holding company and, in a sense, withdraw the insurance from those items?

Mr. SEYMOUR. Absolutely. I agree with that as an appropriate response to the situation as long as the insurance company makes the decision that that product is unsafe and unsound and to go straight to the issue, as long as it's not the Federal chartering authority, the Home Loan Bank Board System.

The CHAIRMAN. Well, I think this isn't hair-splitting, but the point is that decision at the Federal level is a shared decision. That's a decision of when we write the law initially we set the outer bounds, and then the regulatory authorities have certain latitudes within those outer bounds. So, those decisions don't reside solely at one point. We're a government of divided powers at the Federal level, and you have to have a blended judgment as to what's in or what's out of the situation.

I don't know that we will ever have a system at the Federal level where a single decision maker or a single point of decision, i.e. a discreet regulatory body, will have absolute range to decide what's in and what's out and what's yes and what's no. I don't think that's sound and that's not the way we normally do it.

You might like that idea because it might give you more latitude and more running room on what you would like to do, but I don't think it even works that way in your own States.

DETERMINATION OF SAFETY AND SOUNDNESS

Mr. SEYMOUR. No. Actually, I'd like the insurer to have the authority to make the determination of safety and soundness solely so that latitude is not permissible, so that the answer is clear.

You made an excellent plea I think for the fact that regulation in the past at least under the Federal Home Loan Bank Board System has not been that good. And quite frankly, individually—not from ACSSS—individually, I would support that point of view. I don't think it has been that good either.

But I would take that down to the primary reason why which was their structure and the fact that in addition to needing to tighten up regulation we need to make regulation clearer, cleaner. Who makes the decision? There is a clearer and cleaner system on the bank side. The FDIC is primarily responsible for the determination of safety and soundness of activities of banks. Agreed, it's a conversational activity, but FDIC fundamentally is the insurer and they make that decision.

All we are asking for, the States are asking for, if there's one thing we can leave with you that we are asking for, is the same system. Just let the FSLIC or the SAIF or the new FDIC have the authority to primarily make that decision on safety and soundness grounds and get the uncleanliness, the poor administration of the Home Loan Bank Board System out of that decision.

The CHAIRMAN. I'm sure, as you just made the point yourself, you've seen examples recently in terms of Federal regulation where they haven't been very good. I'm paraphrasing what you yourself just said. We don't always get good regulators. Sometimes we get a good one. Sometimes we get a terrible regulator. The same is true at the State level. So, we really need two things. We need to try to get the good regulator every time and get rid of the bad regulator when they come along. We also need to have a system with enough tightness in it and enough solidness that it can survive even a bad regulator because we tend to get I think too many bad regulators. You're examples on the other side of very effective and highly regarded regulators, but I've seen as many breakdowns in the regulatory process as I have in the law writing process. I don't want to have a single failure point that if it goes it can basically take the whole system with it. You've got to help us think about this from the point of view that we're a $100 billion of losses later, and so, when we take a look at it as to how we not only address that problem, we must also determine how we take a look at the system to find out where any of the sensitive failure points were that helped to contribute to this problem and try to fix each one.

Mr. KUTHY. In that connection, Senator, I would submit, for example, that if we look at each of the powers that has been granted by any Federal or State regulator and have an assessment made by the FDIC with a proper process on the flexibility and usefulness of that power, and if we wish to establish it de novo it would make sense. Even questions of issuing bank charters. We note, for example, that in Texas one of the significant contributions to the debacle in that State was the fact that the comptroller of the currency between the years 1982 to 1986 chartered 50 percent more banks in that intervening period and only 5 percent new State chartered banks.

Now willy-nilly chartering, willy-nilly offering of powers and services that are beyond the capability of the system, the insurer can handle. All ought to be subject to that process. We note in the bill, for example, that the FDIC seeks and should get the authority to review both de novo Federal S&L charters and de novo comptroller of the currency national bank charters. At the present time, a flaw in the bill is the fact that a comptroller being merely certified to the FDIC that it's examined this bank and it makes sense to issue the charter, and that the powers are OK. The FDIC should not have to take that certification exclusively. It should have the capability to challenge, just like it challenges on the case of the State chartered banks.

The CHAIRMAN. Let me make one announcement. This is an important announcement. We have developed a timetable as to how we intend to proceed from this point, and I'd like to just share it with everyone present.

We will finish our hearing schedule tomorrow and that will take us through 18 days of hearings and that will have given really all of the parties at interest that needed to be heard in this forum the chance to have done so. We will then begin a period for drafting a narrative statement for discussion with the members of the committee when we come back from the Easter recess. That's coming up on April 3. It is our intention to have the structure of a tentative bill or administration bill with modifications and changes ready for finalizing into a committee print. I would envision that during that period of time we would do two things. We would not only prepare the narrative summary of the bill, as we would see it, but also be drafting the specific legislative building blocks that would support that because there's a lot of work involved. This is a 333-page bill and every line is obviously important or it wouldn't be there.

Then, I envision that on April 4 to 6 that we will meet as a committee in informal session to go over that narrative draft and to see if we can arrive at a general understanding as to what will go into the committee print. It takes a while for the legislative counsel to prepare a committee print once we have expressed a view on it so that we can bring it in for markup to the committee.

We expect that that actual preparation of the committee print will occur between April 7 and 12. We will then distribute that committee print to all the members of the committee, and then, our plan is to have the full committee markup off that working document which will be I think quite well refined at that point on April 13 and 14.

We will immediately write the committee report which will take some period of time and there's a certain requirement of distributing it so that other Members of the Senate not on this committee will have access to it and be able to study it and decide how they feel about it. And we will seek a floor schedule date of between the 18th and the 21st from the majority leader to be able to bring the Banking Committee bill to the Senate floor with an intention to act on it at that time and send the bill into conference with the House.

As we have gone over this with our colleagues, the scale of this task is really unprecedented in terms of the work that has to be done and we are going seven days, long hours each day to get this job done properly. We're going as fast as we can within the bounds of doing the job properly. There's a lot at stake here, not just in terms of fixing the system in the future but in making sure that we do it in a way where we don't have a catastrophic failure again in the future.

So this timetable is a very strenuous one for all concerned. I appreciate the work that the staff has been called upon to put in over and above what is normally the case in order to keep us on this time track, but I think this problem requires that and so that's the schedule that we intend to follow.

Gentlemen, you've been very patient to be here today and to answer all the questions and we appreciate your testimony.

The committee stands in recess.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[Response to written questions and additional material supplied for the record follow:]

STATE OF CALIFORNIA
GEORGE DEUKMEJIAN, Governor

DEPARTMENT OF SAVINGS AND LOAN
600 S. COMMONWEALTH AVENUE, LOS ANGELES, CA 90005-4085—(213) 736-2798
350 SANSOME STREET, SAN FRANCISCO, CA 94104—(415) 557-3666

Larry
K!

Please
insert in
the record

RL

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM
WILLIAN J. CRAWFORD

Hearing of March 16, 1989

April 5, 1989

Donald W. Riegle, Jr.
Chairman
c/o Edward M. Malan
United States Senate
Committee on Banking, Housing
& Urban Affairs
Washington, DC 20510-6075

Dear Mr. Malan:

Attached are my response to Senator Riegle's questions. They are my own and not anyone else.

We were burned out of our 15th floor offices March 2, 1989 and on Friday were ordered to evacuate even our small temporary space on the 9th floor. We will be occupying temporary space at 3440 Wilshire Boulevard and should have telephone service by April 10, 1989. In the meantime, I can be contacted through our San Francisco office (415) 557-3666.

Sincerely,

William J. Crawford
WILLIAM J. CRAWFORD
Commissioner

Attachment

Q.1. Witnesses on March 16, 1989 were concerned about the lack of cooperation between federal and state thrift regulators? Mr. Seymour, for example, testified that "the FHLBB has insisted on duplicating everything state regulators do." Has that been your experience in California? If so, why does the Bank Board act in this way, in your estimation?

1. We have great cooperation from the FHLB of San Francisco. They have both the personnel and the money. All of the reserves of the Department of Savings and Loan, State of California will be used up by June 30, 1990. Interstate Banking comes in 1991 - states cannot travel 3000 miles to appraise property. Our funding source diminishes constantly as associations are converted to Federal Charter, American and Gibraltar, plus many others in recent months. You cannot maintain a staff without a funding source.

Q.2. The Bank Board claims that it has solved its supervisory problems. Has it, in your estimation, solved all of its problems? If not, what remains to be done?

2. Problems are not solved and without a lot of courage will never be solved. Who will advocate the monthly adjustable mortgage to spread the interest rate risk inherent in deregulated savings rates to all borrowers? Who will advocate co-insurance so the saver brings creditor discipline to the marketplace? Who will advocate 20% down so there is equity in the property that secures the associations loans? Never again is a sick joke until we bring actuarial soundness to the balance sheet of savings and loans. Seven of the 22 top publicly traded savings and loans stocks are selling for less than 10% of book value - only 3 are selling for more than 90% of book. Forty-five of 195 (23%) California based associations meet the new risk based capital requirements. What do you do with the 150 (77%) who fail the requirements - close them?

Q.3. An article by Kathleen Day in the Washington Post on March 16, 1989 disturbs me. It charges that favoritism has been shown by one of the district banks.

The FHLBanks examine and supervise thrifts in their region. Chairmen and CEOs from prominent local thrifts sit on the board of directors of their FHLBank. This situation offers a potential conflict of interest. The Post article cites 4 instances where this conflict appears to have been abused at the Dallas district bank.

Do you know of conflict abuses that have occurred at any of the FHLBanks? Do you believe that the potential for conflicts requires that the responsibility for examination and supervision be taken away from the district banks? Where should that responsibility reside, in your opinion?

3. The new directorship appointment system should cure this. District bank exam and supervision is very high professional quality.

Q.4. Please confirm whether you agree with Mr. Kuthy that the FDIC rather than the FHLBS should be the primary regulator of state-chartered thrifts? Why not have the FDIC examine and supervise all thrifts?

4. That FDIC is better is a myth. FHLB personnel were taken from civil service and paid corporate private enterpirse salaries to attract better personnel. FDIC has less problems because banks can adjust the interest rates on assets fast. If they make the mortgage loans that can't be adjusted quickly and high percent loan to value they will be just as sick and the FDIC won't save them. Give the banks the myth that borrowers don't have to pay the cost of money and overhead and they will be just as sick as the savings and loans. Take FDIC personnel out from under civil service and their personnel will improve with higher salaries. Good personnel is cheap when you consider the losses to Federal insurance. FDIC civil servants supervising higher paid FHLBs personnel is counter-productive. It ruins the morale of both.

Q.5 There is evidently a large number of failed thrifts in some states that are costing FSLIC a large amount of money. The problem cannot just be regional economies, because California is one of those states, yet it is not depressed.

In your estimation, have inadequacies in any state's system of examination and supervision contributed to the bill facing FSLIC? What needs to be done to remedy any problems that you perceive?

5. Yes, blanket them into the Federal system. Don't let them dwindle out of existence in consolidation. Wasting their talent is also counter-productive.

Q.6. How often do state regulators examine a) state-chartered thrifts and b) state-chartered banks?

6. (a) Savings and Loan about every 18 months
(b) (Contact California State Banking Department)

Q.7. What is the typical level of experience of a) state thrift examiners and b) state bank examiners.

7. (a) Savings and Loan - 3-1/2 years
(b) (Contact California State Banking Department)

Q.8. State regulators may take custody as a receiver or as a conservator of state-chartered banks and thrifts at the request of either the federal or the state authorities. Please provide data that distinguish by source of the request for banks and thrifts separately. What have been the outcomes of these actions?

Q.8. California

(a) Savings and loan's are taken when FHLB and FSLIC are ready. The State never appointed one for 35 years until I started appointing my Chief Deputy as Conservator in 1986 or 1987. We have appointed him 4 times:
- North America
- First California Savings Bank
- Universal
- Viking

(b) (Contact California State Banking Department)

Q.9. What factors explain the frequency or infrequency of such state custodial actions?

Q.9. Discussion with FHLB of San Francisco. We are improving our Savings and Loan Code with SB 391 to have all grounds of FSLIC - FHLB - and California Banking Department. We should have it during April 1989 and will use it to help the Feds when they need a quick response.

Q.10. The Federal Home Loan Banks examine and supervise state-chartered thrifts for the Bank Board. Do you have any observations on their performance of this task?

Q.10. I'd tune it to reality by asking the eleven durable associations with over $800 million in net worth how to solve the problem so "never again" would mean something.

Q.11. If you could change one thing in the Administration's bill, what would you pick and why?

Questions for Mr. Seymour from Senator Donald W. Riegle Jr.
Hearing March 16, 1989

Q.1. In your testimony you contrast the partnership that exist between the state and federal banking regulators and the lack of cooperation in the thrift industry -- "the FHLBB has insisted on duplicating everything state regulators do." Why does the Bank Board act this way, in your estimation?

1. The fundamental cause of the lack of cooperation that exists between the Federal Home Loan Bank Board system and state regulators is primarily the result of the structure of the Home Loan Bank Board system. Because the Home Loan Bank Board governs the chartering authority, the insurance company and the discount window, it has been possible to develop a policy position, whether formal or informal, which allowed the Bank Board to feel that it was the predominant authority in regulating savings and loans in the United States and that the implementation of that predominance could be applied across all facets of regulation: i.e., insurance as well as chartering authority.

   In contrast, because the bank regulatory system has divided these separate functions of bank regulation between institutions with singular responsibilities, the FDIC is concerned only with insurance, implementation of a policy of predominance has not been possible. Additionally the separation of these functions has created an attitude among federal bank regulators to be cooperative with their peers, either state or federal, in performing the function of bank regulators. Such cooperation was totally lacking at the Federal Home Loan Bank Board.

   The Bank Board's policy of unnecessarily and wastefully duplicating everything state regulators do is not a very rational policy and is therefore difficult to explain, except as a possible result of the hegemony mentioned above.

Q.2. The Bank Board claims that it has solved its supervisory problems. Has it, in your estimation, solved all of its problems? If not, what remains to be done?

2. We do not believe that the Bank Board has solved any of its major supervisory problems. Remaining areas of supervisory concerns are:

   a. adequate and timely examinations;

   b. swift and consistent supervisory action whenever and wherever abuses or unsafe or unsound conditions exist;

   c. recognition of problem areas;

   d. providing for a smooth flow of supervisory policy initiatives from the Bank Board to the level of implementation through the local district banks;

   e. setting insurance premiums at a rate which adequately supports the capital requirements of the FSLIC; and

   f. resolving the disposition of assets currently held or supervised by FADA.

Q.3. An article by Kathleen Day in the Washington Post on March 16, 1989 disturbs me. It charges that favoritism has been shown by one of the district banks.

The FHLBanks examine and supervise thrifts in their region. Chairmen and CEOs from prominent local thrifts sit on the board of directors of their FHLBank. This situation offers a potential conflict of interest. The Post article cites 4 instances where this conflict appears to have been abused at the Dallas district bank.

Do you know of conflict abuses that have occurred at any of the FHLBanks? Do you believe that the potential for conflicts requires that the responsibility for examination and supervision be taken away from the district banks? Where should that responsibility reside, in your opinion?

3. In Illinois it has generally been the understanding, as well as my practical experience, that the Board of Directors of the Federal Home Loan Bank of Chicago has not felt that it had a right or responsibility to interfere with the supervisory responsibility of the district bank. However, a potential exists for such interference to occur. Thus, ACSSS believes that supervision of institutions is best done as close as possible to those institutions. Overall, regulatory authority for savings and loans should be removed from any potential interference by individual institutional concerns.

   While we do not oppose the shifting of the Federal Home Loan Bank system's regulatory function to a more independent federal agency, we do not want the system's credit function to be impaired. The borrowing and lending functions of the district banks should remain independent of any federal department.

Q.4. Please confirm whether you agree with Mr. Kuthy that the FDIC rather than the FHLBS should be the primary regulator of state-chartered thrifts? Why not have the FDIC examine and supervise all thrifts?

4. ACSSS agrees that the FDIC rather than the Federal Home Loan Bank Board should be the federal regulator of state chartered thrifts. This premise was the primary thrust of our testimony. We believe that the FDIC should have overall authority of determining insurance issues for all members of the insurance fund, whether a state or federal savings and loan. ACSSS can see no role for the Federal Home Loan Bank system in regulating state-chartered institutions. To allow the Bank Board system to participate in regulations will only lead to confusion and inconsistency.

Q.5 There is evidently a large number of failed thrifts in some states that are costing FSLIC a large amount of money. The problem cannot just be regional economies, because California is one of those states, yet it is not depressed.

In your estimation, have inadequacies in any state's system of examination and supervision contributed to the bill facing FSLIC? What needs to be done to remedy any problems that you perceive?

5. Certainly, state and federal inadequacies have contributed to the bill facing FSLIC. The truth is that there is no single, simple cause of the current thrift crisis. Instead, the crisis has been precipitated by the adverse effects of several factors -- some controllable, some not -- that have worked against the safety and stability of the industry.

Some of the fundamental causes were: uncontrollable macroeconomic forces; a well-intentioned but poorly planned deregulation effort; excessively liberal investment authority at federal as well as state levels; poor regulatory enforcement; undue industry influence on the processes of government; and outright mismanagement, greed, fraud, and incompetence.

In fact, in Illinois, as I am sure is the case in other states, the state regulatory system has contributed many of the solutions for individual institutions which has caused the bill facing FSLIC to be smaller than it could have been.

Q.6. How often do state regulators examine a) state-chartered thrifts and b) state-chartered banks?

6. State regulators as a rule participated with the Federal Home Loan Bank system in an examination process which covers our state-chartered savings and loans in the United States. Because of this, the federal guidelines for examination scheduling are accepted and utilized by the states. In Illinois, state law requires our savings and loans to be examined every 18 months, at a minimum, and this requirement has always been met. The state-chartered bank examination schedule would be better addressed to Mr. Kuthy.

Q.7. What is the typical level of experience of a) state thrift examiners and b) state bank examiners.

7. I do not have sufficient information to formulate a response to this question.

Q.8. State regulators may take custody as a receiver or as a conservator of state-chartered banks and thrifts at the request of either the federal or the state authorities. Please provide data that distinguish by source of the request for banks and thrifts separately. What have been the outcomes of these actions?

8. I am not sure that this information is available within the time frame requested to answer this question. I am not even sure that it is at all available. Whenever a state-chartered savings and loan in Illinois has been put into custodianship or receivership it has been at the request of the state authority but with concurrent and joint agreement with the district bank. CSBS would have to respond to the bank experiences.

Q.9. What factors explain the frequency or infrequency of such state custodial actions?

9. The primary factor which causes the initiation of a custodial or receiver action of a savings and loan is insolvency of the institution. If the opinion of the state authority is that the management and board of directors of the state-chartered institution is still capable of managing an insolvent state-chartered thrift, the custodial or receiver action is forestalled as long as the principle supervisory agency for the FSLIC concurs. Again, the experience of state bank regulators would be best addressed to Mr. Kuthy.

Q.10. The Federal Home Loan Banks examine and supervise state-chartered thrifts for the Bank Board. Do you have any observations on their performance of this task?

10. The examination staff of the district home loan banks have generally done an adequate job in the performance of their examinations. If there were a single criticism that I would lodge against the Federal Home Loan Bank Board examining process it is that there has been some over staffing by the federal district bank of specific institution examinations; but this has not been a consistent problem.

Q.11. If you could change one thing in the Administration's bill, what would you pick and why?

11. If ACSSS could focus on one single change that is required in the Administration's bill it would be the removal of the Federal Home Loan Bank System's regulatory authority over state-chartered thrifts and transferring that authority solely to the FDIC.

Questions for Mr. Kuthy from Senator Donald W. Riegle Jr.
Hearing March 16, 1989

Q.1. In your testimony you state that "cooperation between the state and federal regulators has been nonexistent." Clearly this is a serious situation. The Bank Board has told this Committee that its problems in the area of supervision and regulation are in the past. It now is proud of its system. Has the problem of lack of cooperation been solved, in your estimation?

1. No. On November 24, 1987, I wrote a letter to Chairman Wall proposing a coordinated examination approach to the examiner of Michigan's state-chartered savings and loan associations. This proposal was rejected by Chairman Wall. We subsequently wrote the Chairman and asked him to reconsider our proposal and have yet to receive a reply to our reconsideration request. (See attached three letters.)

We can think of no instances in recent times where the Bank Board has made even an effort to cooperate with this office in putting together an examination and supervision program that would allow us to better accomplish our mutual objective of safe and sound associations.

We have no data on the Bank Board's cooperation with other states; however, anecdotal evidence from conversations with other state supervisors suggests that Michigan's experience is one shared by many states.

Q.2. An article by Kathleen Day in the Washington Post on March 16, 1989 disturbs me. It charges that favoritism has been shown by one of the district banks.

The FHLBanks examine and supervise thrifts in their region. Chairmen and CEOs from prominent local thrifts sit on the board of directors of their FHLBank. This situation presents a potential conflict of interest. The Post article cites 4 instances where this conflict appears to have been abused at the Dallas district bank.

Do you know of conflict abuses that have occurred at any of the FHLBanks? Do you believe that the potential for conflicts requires that the responsibility for examination and supervision be taken away from the district banks? Where should that responsibility reside, in your opinion?

2. Regulation of savings and loans by the Federal Home Loan Banks is a key flaw of the industry's regulatory structure. Employees of the Federal Home Loan Banks, including FSLIC supervisory personnel, are not civil servants. They are accountable to the Banks' shareholders, which are the supervised institutions. This structure creates inherent conflicts of interest which badly compromise the independence of the insurer. This is one of the reasons we believe that Bank Board supervision of savings and loans was often less stringent than state supervision.

To address these conflicts of interest, CSBS believes it is absolutely necessary to separate the thrift industry's insurer from its charterer, and to make the FDIC the primary Federal regulator of state-chartered savings and loans. It is also important that firm lines of accountability be established from the Federal Home Loan Banks to the Chairman of the System.

Q.3. In your testimony you point out that the failure rate among state-chartered thrifts in Texas is not far out of line with that of federal institutions in that state.

However, when the Bank Board takes over a troubled thrift it typically converts it to a federal mutual charter. Adjusting for such charter changes, 59 state-chartered Texas thrifts required assistance in 1988. That number is more than twice the 22 federal thrifts that were aided by FSLIC in Texas last year. Moreover, Bank Board data show that the costs of resolving state-chartered thrifts is higher. Those higher cost refer not just to total outlays but to costs per dollar of assets. Last year the resolution cost across the nation for state institutions was 26.8 cents on the dollar compared to 21.1 cents for federal S&Ls. In Texas, the numbers were 47.8 cents for state S&Ls and 33.7 cents for federal thrifts.

There is evidently a problem in some states that is costing FSLIC a large amount of money. The problem cannot just be — regional economies, because California shares the problem, yet it is not depressed.

In your estimation, have inadequacies in any state's system of examination and supervision contributed to the bill facing FSLIC? What needs to be done to remedy any problems that you perceive?

Do you believe that extended powers in any of the states have contributed to the bill facing FSLIC?

3. Although state charters accounted for 72% of thrift institutions resolved in Texas in 1988, 75% of all Texas savings associations were state-chartered at the beginning of that year, even after some had been converted to federal charters under the Management Consignment Program.

The high cost of resolving all failed institutions in Texas is largely due to the collapse of drastically inflated land values in that region. The fact that all savings associations were authorized by Federal law to lend 100% of appraised value on residential and commercial real estate accounts for a large part of the total bill, as do acquisition, development and construction (ADC) loans, which were not counted as "direct investment" until 1985.

There was obviously a supervisory collapse in Texas as well, at both state and federal levels. Both the Federal Home Loan Bank of Dallas and the Texas Savings and Loan Department were acutely understaffed and unprepared for the frantic growth of Texas thrifts in the early 1980's. This inadequacy was exacerbated by an absence of cooperation between the state and federal regulators, who although understaffed insisted on duplicating each other's efforts.

Because both regulators were operating in their roles as charterers and no one was looking after the interest of the insurance fund, state and federal thrift supervisors in Texas essentially competed for charters through lax regulation.

This scenario was repeated in California, where the passage of Garn-St. Germain and the encouragement of the Federal Home Loan Banks convinced many savings and loans to convert to federal charters. The California state legislature passed broader investment powers in an effort to entice these institutions back to a state charter. In this attempt it was only partially successful, since from 1980-1987 29 thrifts converted from state to federal charters but only 11 converted from state to federal. At the same time, both state and federal regulators were chartering institutions which did not meet minimum capital standards; the Bank Board was allowing these institutions to join the System and FSLIC was insuring their deposits. The absence of an independent insurer to police these dangerous "charter wars" undoubtedly contributed to the size of the problem in California.

Certainly, inadequacies in state supervision in a handful of states have contributed to tha size of the problem facing the FSLIC. CSBS does not seek to defend these inadequacies. However, FSLIC itself grossly neglected or ignored its own responsibilities in the early 1980's. As an arm of the Bank Board, it had no real independent authority to protect itself from the activities of the federal or the state charterers.

The single most important remedy to this problem is one addressed in S. 413: separating the Savings Association Insurance Fund from the Federal Home Loan Bank Board. As the bill is currently drafted, the separation is incomplete because the Bank System is given primary Federal regulatory authority over state-chartered banks.

Q.4 The Federal Home Loan Banks examine and supervise state-chartered thrifts for the Bank Board. Do you have any observations concerning their performance of this task?

4. As stated previously, the Federal Home Loan Banks should not be supervising state-chartered savings associations. The Bank Board should, and does set rules for membership in the Federal Home Loan Bank System which state-chartered savings and loans must follow. However, its role as a promoter of housing finance interferes with its new mandate to regulate for safety and soundness. Primary federal regulatory authority over state-chartered thrifts should go to the deposit insurer.

Q.5. How often do state regulators examine a) state-chartered thrifts and b) state-chartered banks?

5. Most states require that state-chartered banks be examined at least every 18 months. Some require examinations every two years or every three years; a few leave scheduling to the discretion of the state supervisor. Attached is a table listing each state's requirements. The requirements apply only to healthy banks; problem banks are monitored and examined more frequently, by both federal and state supervisors.

Michigan thrifts must be examined every 12 months. We do not have information on requirements for savings and loans in other states.

Q.6. What is the typical level of experience of a) state thrift examiners and b) state bank examiners?

6. It would be impossible to say what the "typical" level of experience of state bank examiners is. Attached are tables showing examiner length of service on a state-by-state basis, and overall turnover rates experienced by state departments. These turnover rates are in line with those experienced by the FDIC, and below those experienced by the OCC.

We have no information on the level of experience of state thrift examiners, except in those states where field examination forces are consolidated.

Q.7. State regulators may take custody as a receiver or as a conservator of state-chartered banks and thrifts at the request of either the federal or the state authorities. Please provide data that distinguish by source of the request for banks and thrifts separately. What have been the outcomes of these actions?

Q.8 What factors explain the frequency or infrequency of such state custodial actions?

7. & 8. Although a few state statutes do still authorize the state supervisor to act as receiver or conservator of a failed state-chartered bank, we know of no instances in which a state bank supervisor closed an FDIC-insured institution and failed to name the FDIC receiver. Most state statutes require the bank supervisor to appoint the FDIC receiver after closing a state-chartered bank. We are not aware of any differences in the FSLIC's receivership powers, nor of any cases in which the state thrift supervisor served as receiver, although these may exist.

Rarely, in the cases of uninsured or state-insured institutions, states have had to step in as receiver of failed institutions. This occurred when state-insured savings and loans failed in Ohio and in Maryland, and created many problems for depositors and for the state.

Attachment 1
Question #1

STATE OF MICHIGAN

UGENE W. KUTHY
Commissioner

JAMES J. BLANCHARD, Governor
DEPARTMENT OF COMMERCE
DOUG ROSS, Director

FINANCIAL INSTITUTIONS BUREAU
P.O. Box 30224
Lansing, Michigan 48909

September 30, 1987

M. Danny Wall, Chairman
Federal Home Loan Bank Board
1700 G Street, N. W.
Washington, D.C. 20552

Dear Chairman Wall:

Congratulations on your appointment as Chairman of the Federal Home Loan Bank Board (Board). I am sure that the Board will benefit from your leadership as it grapples with some of the difficult issues it faces. My best wishes to you for a successful tenure.

This is also a good opportunity to present for your consideration a proposal that could help to lessen the pressures on your agency and staff. I suggest that the Board adopt an examination program similar to that of the Federal Deposit Insurance Corporation and of the Federal Reserve Board. Under such a program, the Board would examine on an annual basis those institutions with a CAMEL rating of three, four and five; every third year, it would examine those state associations that have a CAMEL rating of one or two. The state would continue to examine all state-chartered institutions annually.

This proposal assumes that the state examination report is produced by an accredited regulatory agency or that the report meets Board standards. Many states have examination programs similar to Michigan's, in which the state examines banks, savings and loans, and possibly credit unions. Many of these same states are also accredited by the Conference of State Bank Supervisors (CSBS). The American Council of State Savings Supervisors (ACSSS) is presently developing an accreditation plan patterned after that of CSBS.

As you may know, Michigan has adopted an independent examination program. The reasons for our doing so are: (1) our standards, such as capital requirements, position on growth, and the need for appropriate policies, were generally more stringent than the Board requirement; (2) the lack of financial support from the savings and loan industry prohibited adding savings and loan examiners; and (3) Michigan was reduced to one savings and loan examiner, which shifted the examination burden to the Board examiners.

Our independent examination program uses other Financial Institutions Bureau examiners. I am comfortable with this arrangement because the average tenure of our examiners is more than ten years, and they have gained substantial experience from examining small to multi-billion dollar institutions. It is Michigan's experience that spurred me to propose this federal/state examination program for state associations.

This proposed program would accomplish several objectives. First, it would allow the Board to focus the energies of its staff upon the problem institutions, which is more efficient from a cost and operations perspective. Secondly, the financial cost to the well-run institutions would be lower, since the examination frequency would be reduced. Operationally, the associations would benefit from fewer examinations disrupting the work process; furthermore, unnecessary examination duplications and redundancies would be eliminated. This program also supports the dual system of regulation because it would encourage the states to establish and maintain strong examination programs. Thus, the program would serve to develop and perpetuate a strong regulatory system in this country that does not ignore the significant strengths existing in the current state systems.

Finally, and perhaps most importantly, this program would encourage the several states and the Board to work as a unified force to accomplish a common goal. This latter purpose, while desirable, has not always been a reality. I encourage and welcome your consideration of this proposal. If you would like to discuss this by phone or in person, or if you have questions, please call me at (517) 373-3460. I look forward to hearing from you.

Sincerely,

Eugene W. Kuthy

Eugene W. Kuthy
Commissioner

lb
cc: ACSSS

Federal Home Loan Bank Board
OFFICE OF THE CHAIRMAN

M. DANNY WALL, Chairman

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

November 24, 1987

DEPARTMENT OF COMMERCE
FINANCIAL INSTITUTIONS
BUREAU
1987 NOV 30 AM 9 02

Mr. Eugene W. Kuthy, Commissioner
Financial Institutions Bureau
P.O. Box 30224
Lansing, Michigan 48909

Dear Commissioner Kuthy:

Thank you very much for your letter of September 30, 1987, in which you presented your proposal for an examination program which would incorporate accreditation for state regulatory authorities and a lessened Federal role in the examination of state-chartered institutions with a CAMEL rating of one or two.

I fully endorse improved coordination and cooperation between the Federal Home Loan Bank System and State supervisors. In this regard, I have asked Darrel Dochow, Executive Director of our Office of Regulatory Policy, Oversight and Supervision (ORPOS), to act as our liaison on all national supervisory matters.

The use of an accreditation program as a means of having states conduct the sole examination and supervision of state-chartered institutions is an obviously sensitive matter for the Bank Board. This will remain true as long as the FSLIC stands behind losses in the insured institutions. That does not mean that there is no possibility of making progress in this area and we fully support all parties involved continuously working to enhance thrift examination and supervision. The appropriate route to pursue would seem to be to have ORPOS review the accreditation proposals to determine what possibilities exist. I have recently written to William Drohan, President of the American Council of State Savings Supervisors, suggesting that avenue.

Reducing the frequency of the Federal examination of state-chartered institutions with a rating of one or two would make us most uncomfortable. As you know, the ratings assigned to the thrift institutions have a high degree of subjectivity. In todays still volatile atmosphere, the condition of an institution (and, therefore, its appropriate rating) can change quite rapidly. Therefore, we believe that Federal participation in examinations of all insured institutions is necessary. You may wish to explore with Mr. Dochow and Mr. Ronald Morphew, Principal Supervisory Agent at the Federal Home Loan Bank of Indianapolis, another possibility.

Mr. Eugene W. Kuthy
Commissioner
Financial Institutions Bureau
Page 2

You say that you are now using Financial Institutions Bureau examiners to conduct your examination program and that you are comfortable with that arrangement. It may be feasible to do the examinations of the one or two rated state-chartered institutions on a joint basis with a lesser Federal participation than in the past. In other words, the key variable would be crew mix rather than the timing of Federal participation.

Again, I thank you very much for your views and comments. I look forward to working with you and the other State supervisors during my tenure as Chairman of the Federal Home Loan Bank Board.

Sincerely,

Dan Wall

M. Danny Wall
Chairman

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STATE OF MICHIGAN

EUGENE W. KUTHY
Commissioner

JAMES J. BLANCHARD, Governor
DEPARTMENT OF COMMERCE
DOUG ROSS, Director

FINANCIAL INSTITUTIONS BUREAU
P.O. Box 30224
Lansing, Michigan 48909

January 27, 1988

No reply to this letter

M. Danny Wall, Chairman
Federal Home Loan Bank Board
1700 G Street N. W.
Washington, D.C. 20552

Dear Chairman Wall:

This will acknowledge and thank you for your letter of November 24, 1987, concerning our proposal to you of September 30, 1987, concerning the examination of Michigan's state chartered savings and loan associations.

In your reply you have rejected our proposal for reducing the frequency of Federal examinations of state-chartered institutions with a rating of one or two. You have given as your basis for rejecting our proposal the high degree of subjectivity of the ratings assigned and that these ratings can change quite rapidly in today's volatile atmosphere. While we can agree that the ratings are somewhat subjective and can change quite rapidly, we cannot accept this rationale as an adequate basis for rejecting our proposal.

We feel that our examiner personnel have the professional expertise and ability to assess the condition and assign ratings to the associations that we have chartered. The FIB has the responsibility for ensuring that state chartered associations operate in a safe and sound manner. We therefore believe that our examination, monitoring and supervision programs are effective in identifying conditions, trends and practices that could cause an association rating to change.

Your rejection of our proposal seems to suggest that only your people have the necessary experience, expertise and programs that can identify a one or two rated association that is moving in the direction of becoming a supervisory problem. We strongly disagree.

We understand your responsibility as an insurer and do not question your authority to carry out this responsibility. We only suggest that your resources might be better utilized by accepting examinations conducted by FIB examiners as your monitoring system for the one and two rated associations and that your direct involvement with state chartered associations be limited to situations that present a material risk to the insurance fund.

M. Danny Wall
January 27, 1988
Page Two

We ask that you reconsider our proposal to reduce the frequency of examinations conducted by your people of those associations identified by us as being rated a one or two. I would welcome the opportunity to meet with you and discuss this proposal in more detail or answer any questions you might have.

Sincerely,

Eugene W. Kuthy

Eugene W. Kuthy
Commissioner

EWK:RSK:ps

Attachment 2
Question #5

REQUIRED FREQUENCY OF BANK EXAMINATIONS, DECEMBER 31, 1987

State	Every 12 mo.	Every 18 mo.	Other	FDIC and/or FRS exam. acceptable in lieu of state exam. by statute
Alabama	X			Yes
Alaska	X			Yes
Arizona			Once every two years	Yes
Arkansas			Once every two years	No
California			Once every two years	No
Colorado	X			No
Connecticut			As often as deemed necessary	Yes[1]
Delaware			As often as deemed necessary	Yes
Florida		X		Yes
Georgia	X			Yes
Hawaii		X		No
Idaho		X		Yes
Illinois	X			No
Indiana			As often as deemed necessary	Yes
Iowa		X		No
Kansas		X		Yes
Kentucky			Once every two years	No
Louisiana			As often as deemed necessary	Yes
Maine			Once every three years	Yes
Maryland	X			Yes
Massachusetts			Once every two years	No
Michigan	X			Yes
Minnesota		X		Yes
Mississippi	X			Yes
Missouri	X			Yes
Montana			Once every thirty months	Yes
Nebraska			Determined by the Director	Yes
Nevada		X		Yes[2]
New Hampshire		X		Yes
New Jersey			At discretion of Commissioner	No
New Mexico	X			Yes
New York	X			No
North Carolina		X		As part only
North Dakota			Once every thirty months	Yes
Ohio		X		Yes
Oklahoma		X		Yes
Oregon			Once every two years	Yes
Pennsylvania			Once every two years	Yes
Puerto Rico	X			No
Rhode Island	X			Yes
South Carolina		X		No
South Dakota			Once every two years	Yes
Tennessee			Once every three years	Yes
Texas	X			Yes
Utah			Determined by Commissioner	Yes
Vermont			Once every three years	Yes
Virginia			Twice every three years	No
Virgin Islands	X			Yes
Washington		X		Yes
West Virginia		X		Yes
Wisconsin	X			Yes
Wyoming	X			Yes

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[1] Accepted by policy, not statute.

[2] On an alternating basis.

Attachment 3
Question #6

NUMBER OF FIELD EXAMINERS AND LENGTH OF SERVICE, DECEMBER 31, 1987

State	Number of field examiners		Number of CB field examiners		Length of service (years) of CB examiners 12/31/87			
	December 31, 1986	December 31, 1987	December 31, 1986	December 31, 1987	Under 2	2-5	5-10	Over 10
Alabama	40	40	36	35	6	7	12	10
Alaska	3	3	3	3	0	2	1	0
Arizona	34	46	7	8	3	5	0	0
Arkansas	32	37	31	35	13	13	7	2
California	116	118	116	118	27	28	24	39
Colorado[4]	—	—	—	—	—	—	—	—
Connecticut	44	49	39	41	7	8	1	25
Delaware	16	19	16	19	8	5	3	3
Florida	92	90	60	60	20	8	18	14
Georgia	72	78	72	78	20	21	16	21
Guam	6	6	6	6	1	2	2	1
Hawaii	12	14	12	14	2	0	6	6
Idaho	12	15	8	9	2	3	3	1
Illinois	133	144	111	115	41[1]	53[1]	15[1]	35[1]
Indiana	76	78	43	44	21	12	7	4
Iowa	87	93	85	90	36	30	11	13
Kansas	51	51	51	51	9	24	11	7
Kentucky	44	48	37	40	13	9	4	14
Louisiana	82	89	63	68	28	16	15	10
Maine	11	11	11	11	0	0	5	6
Maryland	20	25	15	19	8	1	2	8
Massachusetts	105	105	(2)	(2)	13	12	19	61
Michigan	73	79	43	49	6	10	6	23
Minnesota	56	62	45	50	6	13	9	22
Mississippi	26	29	20	22	5	5	4	8
Missouri	95	95	87	87	39	23	16	9
Montana	16	15	15	14	3	3	4	4
Nebraska	39	39	36	35	11	12	2	10
Nevada	10	12	10	12	2	2	5	3
New Hampshire	12	15	12	15	2	1	2	10
New Jersey	35	33	35	33	1	5	8	19
New Mexico	9	14	7	12	9	2	0	1
New York	183	176	(2)	(2)	25	7	42	102
North Carolina	20	21	17	18	6[1]	2[1]	4[1]	9[1]
North Dakota	14	16	12	14	9	4	0	1
Ohio	34	34	29	32	5	10	10	7
Oklahoma	39	40	37	38	16	11	2	9
Oregon	26	14	22	11	0	1	2	8
Pennsylvania	87	89	51	54	0	5	13	36
Puerto Rico	30	31	30	13[3]	0	2	7	4
Rhode Island	13	9	13	9	2	1	1	5
South Carolina	19	19	17	17	7	3	4	3
South Dakota	14	14	14	14	6	5	1	2
Tennessee	67	66	47	46	16	10	7	13
Texas	101	153	92	139	79	51	8	1
Utah	16	21	6	7	3	1	1	2
Vermont	8	10	8	5	2	1	2	0
Virginia	45	57	36	48	24	7	8	9
Washington	23	23	22	22	4[1]	5[1]	8[1]	6[1]
West Virginia	14	17	14	17	7	4	5	1
Wisconsin	49	59	44	54	21	10	9	14
Wyoming	11	14	11	14	10	1	1	2

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[1] Length of service for all field examiners

[2] Examiners examine all types of financial institutions

[3] In 1987, field examiners were divided into commercial bank examiners and other financial institution examiners

[4] The information was not provided by the state banking department

Attachment 4
Question #6

TURNOVER OF COMMERCIAL BANK FIELD EXAMINERS
Expressed as a Percent

STATE	1986	1987	1988
Alabama	5	5	5
Alaska	17	0	0
Arizona	22	40	na
Arkansas	12	16	10
California	19	8	2
Colorado	4	0	0
Connecticut	na	na	na
Delaware	11	21	5
Florida	8	13	17
Georgia	12	4	10
Hawaii	13	0	7
Idaho	14	0	18
Illinois	12	6	8
Indiana	11	16	19
Iowa	32	15	10
Kansas	4	1	1
Kentucky	8	2	9
Louisiana	17	8	14
Maine	0	0	39
Maryland	0	0	0
Massachusetts	0	0	0
Michigan	3	3	3
Minnesota	4	4	4
Mississippi	5	5	10
Missouri	23	16	16
Montana	7	7	27
Nebraska	9	11	0
Nevada	10	0	25
New Hampshire	15	18	7
New Jersey	3	3	6
New Mexico	80	70	80
New York	4	6	4
North Carolina	0	0	5
North Dakota	25	27	7
Ohio	13	13	13
Oklahoma	11	15	15
Oregon	10	42	0
Pennsylvania	18	11	8
Rhode Island	25	35	7
South Carolina	1	1	3

South Dakota	20	30	15
Tennessee	17	9	5
Texas	24	23	20
Utah	0	14	14
Vermont	20	0	0
Virginia	8	3	7
Washington	9	14	24
West Virginia	13	5	24
Wisconsin	22	3	17
Wyoming	0	43	7
Total	12.7%	12.0%	11.4%

PROPOSED TESTIMONY OF WILLIAM J. CRAWFORD
SAVINGS AND LOAN COMMISSIONER
STATE OF CALIFORNIA
BEFORE THE UNITED STATES SENATE
COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS

WASHINGTON, D.C. - MARCH 16, 1989

Thank you for giving me the opportunity to submit my prepared statement regarding the proposed legislation to reorganize deposit insurance and ways to improve it. I wish to stress that the opinions expressed here are my own personal opinions and not necessarily those of the Department of Savings and Loan or the State of California.

It was absolutely necessary that a drastic restructuring be accomplished. However, every major capitalist country provides for a specialized home-financing intermediary whether they call it a family bank, a savings bank, a savings and loan, a building and loan or a building society. This financial structure cannot be substandard to the commercial banks or it will not function properly as the corporate and governmental customers of commercial banks can outbid prospective homeowners for funds. The family bank institution must be on a par with commercial banks and not subservient to them; otherwise they will become second class citizens, which will be the result if the present Bush Plan is implemented as is.

This new family bank industry should have fully monthly adjustable mortgages like the building societies in England. It is my understanding that there are 110 building societies in Great Britain. The largest has $50 billion in assets. It has 750 branches. All mortgages are 12-1/4%. All savings are paid 11% with 2% being withheld and paid to the government as tax and 9% tax paid interest paid to the saver. This gives them 1-1/4% spread for overhead and profit, which represents a very narrow margin. If the cost of funds rises it is immediately passed on to all existing and new borrowers. This way you adjust the rates to attract sufficient money to house the people and the cost is evenly distributed.

Any new laws and regulations should be simple, concise and durable. It makes no sense to have complicated laws on the books that cannot be understood by juries, judges, prosecuting attorneys, and law enforcement officials. We complain that white collar criminals are not punished but the laws change so frequently and are so complicated that crimes committed over a six-year period may involve three changes in law. It is impossible to arouse enthusiasm of law enforcement officials unless there is an acceptable chance for convincing argument and conviction. Today the public is outraged at what has happened, but the permissive and complicated laws are welcome loopholes for expensive defense attorneys to win acquittal. Effective punishment at reasonable cost should be the goal of law and regulation.

In recapitalizing the savings and loan industry you must give consideration to the capital markets' attitude toward the stock of the savings and loan industry. To freely access the capital markets you must earn a competitive rate of return, pay dividends, have a predictable and nonthreatening regulatory climate as well as stable FASB accounting rules. It might also be added that the company or industry needs a track record showing a consistent history of success. In 1968 the Congress of the United States passed a housing bill asking for 26,000,000 units over the next ten years. It never reached that goal in any one of those ten years. In fact, it only exceeded 2,000,000 in about four of those twenty years.

To pay the cost and to provide the incentive to drive money into the low end of the housing market, tax law should be amended to provide for deductibility for 100% of the first $10,000 of home interest expenses paid, 80% of the second $10,000 of home interest paid, 50% of the third $10,000 of home interest paid and nondeductibility of home interest over $30,000. We must not waste building materials and funds on luxury where there are so many people who need shelter. The savings and loan industry should also pay the maximum that it is capable of paying in light of the objective to have them access capital markets by 1991 to bring their net worth to 6% and to compete in a nationwide interstate environment with the giants of the industry.

The free enterprise, free access to enter the savings and loan field sounded like a great concept until we find that there was no free exit. Now we must consolidate the industry in the face of the current plan to establish an international G-10 (G-11) banking agreement that will set international rules for competitive financial institutions. This will make it very difficult for the United States to compete in a worldwide environment where it has internally 51 licensing agencies and one insurance agency.

Since the dual savings and loan system was severely crippled by permitting federal stock companies in 1975 and conversion from state stock to federal stock in 1980, which robbed the states of their assessment base to support adequate independent regulatory oversight, the dual system has been in decline.

In melding together this new national financial system all players should be permitted to use the same insurance emblem to lower their cost of funds to be used for purposes for which they exist. The commercial banking system is making record profits from financing corporations while the savings and loans make losses dealing with individuals. Federal deposit insurance is really a guarantee for everyone with full faith and credit of the United States of America taxpayer behind it. It makes no sense to have the savings and loan industry pay more for insurance to finance housing than banks do to finance commercial lending.

Since the key element of oversight is the experience and streetwise knowledge of examiners, appraisers and other regulators, it would be a waste to allow the human resources that are availabvle in the individual federal home loan banks and the individual state savings and loan regulatory departments to seek jobs elsewhere and transfer their responsibility to FDIC examiners who have far less experience in dealing with residential real estate. Attached hereto are two recent articles from California papers which are self-explanatory in the difficulty of state regulatory bodies to sustain adequate oversight budgets (Exhibits 1 and 2).

By 1995 a massive consolidation needs to occur. We have far too many unprofitable management teams creating and servicing assets in an incompetent manner. In California there are 193 savings and loans. They have 27% of the assets of the industry. If that structure was projected across the United States there would be 556 institutions by the 1991 trigger date for nationwide interstate banking and 6% net worth. I might also allude to the fact that raising the above 6% net worth may be difficult in accessing the capital markets. The March 7, 1989, American Banker lists 22 major publicly traded savings and loan stocks. Only two are selling at book or higher. Only six are selling above 50% of book. Of the 16 that are selling below 50% of book, seven are selling for less than 10% of book. Raising money through capital stock or subordinated debt will be most difficult for these seven institutions. If you raise the special assessments too high, there is probably a 90% chance that the taxpayer will be paying special assessments for at least these seven institutions.

You ask about the changes that were necessary to make certain that the problem did not reoccur. Attached hereto is a copy of an article which I wrote for the Federal Home Loan Bank Outlook in January of 1987 (Exhibit 3). I think it covers most of my recommendations. However, I wish to emphasize the need for simple, concise, jury-understandable laws and regulations that have durability and could possibly be stated in tabular form. We commend the Bush Plan for providing tough civil and criminal penalties. The main effort should be to get diverse ownership of the stock, willingness of capable citizens to serve on boards of directors, some form of co-insurance so savers and creditors monitor where they place their funds and, above all, lending and investment authority to require that the borrower have equity, which is the first line of defense when you ask for prompt payments.

Typically, in writing savings and loan laws and regulations we use the services of attorneys and academia. I heartily recommend that you get the opinions of the capable managers of institutions who now possess a 6% tangible GAAP net worth and have a consistent history of success over a prolonged period of time. They are the durable people who know how to perpetuate a home financing institution. I am sure they can fine tune whatever I have stated above. Attached is a schedule (Exhibit 4) which shows retail, specialized and diversified mortgage lenders are the most profitable long-term.

Third party validators, attorneys, auditors, appraisers and regulators should be held to high fiduciary standards of professionalism. Particular care should be taken to prevent large interest reserve funds to keep loans current and the capitalizing of interest and overhead to add fictitious value to the assets, earnings, and net worth of the institutions.

IT IS TIME FOR CONSOLIDATION, DISCIPLINE AND TRUTH, EVEN IF IT HURTS.

March 14, 1989

LOS ANGELES TIMES - March 11, 1989

State S&L Regulators Hobbled by Lack of Funds, Report Says

By DOUGLAS FRANTZ, *Times Staff Writer*

The California Department of Savings and Loan is almost as bad off as the industry it regulates, according to a report released Friday by a legislative study commission.

The state agency is inadequately staffed, may run out of funds by the end of the fiscal year and is hobbled because its budget comes from the institutions it is supposed to regulate, said the study and its authors.

"The report . . . concludes after two years of study that inadequate support of our state's regulatory system contributed significantly to the financial disaster we are now faced with," Senate President Pro Tem David Roberti (D-Los Angeles) said at a press conference in Los Angeles.

The study was done by the Senate Advisory Commission on Cost Control in State Government. It evaluated the effectiveness of both the state banking department and the savings and loan department, but most of the criticism was directed at the savings and loan agency.

The department regulates the 135 thrifts that operate under California charter. The remaining 70 or so thrifts in the state are federally regulated. All insured institutions, whether supervised by the state or federal regulators, are insured by the federal government.

The state S&L department's $9-million budget comes solely from assessments on the institutions it regulates. Many of the biggest state thrifts converted to federal status in the early 1980s, leaving the state agency to cope with a declining budget as regulatory problems became more complex as a result of the new powers granted to thrifts.

According to the study, the department was forced to relax its supervision of thrifts under threat that they would convert to federal status and further reduce the agency's budget.

William J. Crawford, commissioner of the department, acknowledged the need for a new funding mechanism, but he disputed the assertion that the agency has gone easy on any institution.

Crawford said he cut his own budget last year when he refused to approve a state charter for the new American Savings & Loan after its purchase by Texas investor Robert M. Bass and others. Crawford objected to some of the activities that were being allowed of the new owners, and American eventually obtained a federal charter.

The study said new funds must be found to keep the agency afloat and increase spending for training its examiners. But Roberti acknowledged that persuading the Legislature to appropriate money for the agency might be difficult.

EXHIBIT 1

State S&L regulators lack funds

The Sacramento Bee

Friday, February 24, 1989

By Philip J. Garcia
Bee Staff Writer

While the Bush administration confronts a $100 billion-plus bailout of insolvent savings and loans nationwide, the state agency responsible for regulating California thrifts may be facing insolvency, too.

In its analysis of Gov. Deukmejian's 1989-90 budget proposal, the state's legislative analyst says the proposed budgeted expenses for the state Department of Savings and Loan exceeds by about $2 million the regulatory [illegible] $1.2 million.

At stake is not only the ability of state regulators to police state-chartered thrifts at a time when much of the industry is in turmoil, but perhaps the future existence of the department, observers said.

"Our analysis indicates that additional revenues will be needed if the department's regulatory activities are to continue beyond 1989-90," the legislative analyst's report said.

The review, released Wednesday, said the department's revenue base — funded primarily by assessments against state-chartered thrifts — continues to shrink.

It noted that the department has been able to "sustain expenditures" by "drawing down reserves accumulated in past years." But it cautioned that reserves will essentially be depleted by the end of 1989-90 budget year, leaving a projected reserve of only $155,000. Reserves totaled $4.4 million at the end of the 1986-87 budget year.

The department's revenues are projected to be 10 percent, or $863,000, less in 1989-90 than the amount estimated for the current budget year (1988-89) that ends June 30.

The legislative analyst's report noted that the revenue decrease "is primarily the result of a decrease in the number of state-chartered associations which, in turn, reduces the total assets subject to assessment by the department."

It said "several insolvent state associations have converted from state to federal charter as a result of mergers with other associations or takeover by federal authorities."

For example, the report said, the recent conversion of one large association alone — [illegible] by sources to be American Savings and Loan Association of Stockton — accounted for a loss of about $500,000 in assessments in 1989-90. American Savings was the largest insolvent thrift in the country until it was taken over in late December by Texas billionaire Robert Bass.

By the end of 1988, the number of state-chartered thrifts had decreased to 129 from 155 at the end of 1985, according to a spokesman for the California League of Savings Institutions.

William J. Crawford, the state savings and loan commissioner, said he could not comment on the analysis because he had not seen it.

Asked if assessments were adequate, Crawford said, "It depends on how many people convert (from state-chartered thrifts to federally chartered institutions). We mail the assessments out in June. We'll see what happens."

The analyst's warning comes at a time when legislators are considering a proposal to strengthen the regulatory hand of the S&L commissioner.

Proposed legislation would give Crawford the authority to take over a troubled thrift — including any found to be "acting in an unsafe or unsound manner" — without notice. Currently, the commissioner must conduct examinations and issue reports before appointing a conservator, according to an aide to state Sen. Rose Ann Vuich, D-Dinuba, chairwoman of the state Senate Banking and Commerce Committee.

A hearing on the legislation, introduced by Vuich, is scheduled Wednesday. The bill has the support of the state's savings league.

The push for greater scrutiny at the state level — as at the federal level — follows deregulation that allowed thrifts to engage in investments outside the industry's traditional arena of lending money to consumers to buy a home.

Allowed to expand their lending activities, many thrifts began paying high interest rates to attract deposits at a time when their portfolios were dominated by fixed-rate mortgages, causing profit margins to shrink. Deregulation also made it easier for investors to launch new thrifts.

Last month in San Francisco, the U.S. House Banking Committee heard testimony from witnesses who criticized Crawford's predecessor, Lawrence Taggart, for approving more than 200 state S&L charters from early 1983 until he left office in January 1985.

In contrast, Crawford has approved just one request for a charter since he assumed the post the following month.

The insolvency of failed institutions has the Bush Administration and Congress up against the wall. The administration has announced a $90 billion bailout plan, but Treasury secretary Nicholas Brady has put the figure has high as $230 billion over 30 years.

At the state level, the projected ending balance of $155,000 in reserves for the S&L department "is about 1.6 percent of total expenditures proposed for 1989-90, and, in our judgment, does not provide an adequate reserve to cover unforeseen expenditures or unanticipated delays in the payment of assessments by licensed associations," the state's analyst said.

It suggested that four alternatives be considered, including increasing the assessment rate, instituting charges for certain financial examinations, increasing licensing and other fees and possible consolidation with the state Banking Department.

The report noted that assessments on assets make up about 94 percent of the regulatory fund's revenues, which for 1989-90 are projected on the basis of a rate of 99 cents per $1,000 of assets. But the authors noted that an increase in the assessment rate would give S&Ls the incentive to change to a federal charter, reducing the total assets subject to assessment.

The analysis showed the department has not reviewed its fee structure since 1983-84 and that increased licensing fees could be easily justified.

For instance, the report said, the department estimated the cost to process an application for acquisition runs about $7,500. The current fee, however, is only $750.

Kirk Hallahan, a spokesman for the California savings league, said his organization supports an "adequately funded" savings and loan department.

"We fully support maintaining a strong, viable, adequately funded Department of Savings and Loan . . . versus consolidation (with the state Banking Department)," he said.

In a look at a second regulatory agency, the legislative analyst's report recommended that before budget hearings are held, the departments of Real Estate and Finance explain why staff benefits are underbudgeted for the Department of Real Estate.

The report said underbudgeted staff benefits could force staff vacancies that would cut into regulatory activities, especially oversight of mortgage loan brokers.

EXHIBIT 2

The Case for Discipline in the Thrift Industry

by William J. Crawford

Some people allege that the nation's real estate finance markets are very efficient because of the large borrowing, lending, and investing volumes that the markets generate. Usually the main proponents of this view are those who are taking substantial profits off the top while the government is attaching guarantees. Brokers and builders, as well as current borrowers and savers, love it. But somehow we have lost the gyroscope of stability and have built, through unsafe and unsound investing and lending practices, a staggering total of hidden losses and dislocations that ultimately must be resolved.

Asset quality in financial institutions has been eroding since the 1960s. The rate of this decline has accelerated in the 1980s as diversification, expanded powers, deregulation, and disintilation put unbearable pressures on underwriting and financial reporting. This decline is becoming a permanent industry feature. To rectify matters, steps must be taken to restore balanced discipline to the nation's thrift system.

Absent Borrower Equity

First and foremost, discipline implies restraint on the permissiveness that has nearly destroyed the Federal Savings and Loan Insurance Corporation (FSLIC), and threatens the Federal Deposit Insurance Corporation. Too much money raised at too high a cost, pushed into weakening markets with poor underwriting, has produced such huge losses that we have in two years cleaned out the equivalent of all premiums collected by FSLIC in 52 years and all the investment income earned on those premium funds. The authority given to some institutions, particularly in California, to loan or invest up to 100 percent of collateral value is a colossal bust. Financial institutions are loaded with bad and marginal loans and investments. Prudent loans and investments are those that will be repaid in cash within the contractual period. To take one example, an 80 percent loan on a single-family dwelling, properly underwritten, will break even in a typical market if and when the property is foreclosed with the usual collection procedures. The equity of borrowers in the assets of thrift institutions is the first line of defense against poor discipline.

This ties into another point. Historically, creditors with something to lose have kept nonfinancial corporations on their toes. But creditors of financial institutions—the depositors—can place their money at the highest rate in any institution, solvent or insolvent, and be fully insured to $100,000. The single-stockholder-owned institution can pay the most for the money because it can pass it on through loans and investments that may bypass normal underwriting constraints. Sound underwriters dealing at arm's length cannot compete. By outbidding conforming institutions in the local savings market, the high-risk institution can then use its 100 percent loan and investment powers—if it has them—in distant markets where most of the competitors do not possess those powers. This is truly counterproductive, drawing money from strong markets to weaker markets for higher risks and yields, and bleeding money away from sound projects to the detriment of society. This practice could be deflated by putting depositors—especially wholesale depositors—at some risk, for example, by requiring 90 percent co-insurance for depositors with accounts containing more than $40,000 or some other acceptable limit.

What's Reported vs. What's Real

Net worth is critically important—but the composition of net worth today is a most misleading array of smoke and mirrors. It is supposed to be the net value of assets minus liabilities. But in many cases one must read pages of footnotes to get even a superficial realization of an institution's tangible economic equity. To realize how fragile net worth really is, one only needs to note the wide swings that have occurred in less than one year, from modest positive net worth to substantially negative net worth, for certain institutions. Only after the fact do we have the statutory auditor's explanation for the swing. Financial institutions need tangible economic net worth for a cushion against losses, and depositors and investors must be able to know what that worth is.

Independent auditors with a challenging attitude to reported net worth would help reduce many of the wide swings from initially reported net worth to finally reported net worth. Purchase, push-down, and regulatory accounting inflate net worth beyond reason; the footnotes make it legal, but not economically fair. Corporate raiders have made obsolete the conservative accounting that used to put hidden strength for loss absorption in the balance sheet. Using the lower of cost or market accounting formerly obscured potential profit in some assets that could be sold at a gain on a rainy day to restore health to the company. It can be argued that there is no more accuracy in undervaluing assets than in overvaluing assets. But tell that to conservative farmers who are weathering the current storm while the "mark-to-market" and "borrow-to-market" farmer down the road is attending the auction sale of his farm and equipment.

William J. Crawford is savings and loan commissioner of the State of California.

UTLOCK OF THE FEDERAL
HOME LOAN BANK SYSTEM

EXHIBIT 3

Does Anybody Say No?

Some thrifts have a particular problem: although unbiased evaluation is fundamental to investment of any kind, companies dominated by a single stockholder afford little opportunity for independent thinking and balanced loyalty. Their loan committee and board of directors' minutes might just as well read: "Those in favor say aye; those opposed report to the cashier for severance pay." In many such cases, the full faith and credit of the United States government is being used to back venture capital (savings) to produce loans that are maintained in a contractually current condition for several years by "journalizing" fees and interest income from the loan proceeds. When the due date of the loan approaches, the loan is recast under the theory that a rolling loan gathers no loss. Once the true nature of the transaction is understood and the reality of the loss is known, a number of officers' and employees' careers, as well as the reputations of accommodative directors, go on the line, usually for the last time.

Before April 1982, to obtain insurance of accounts, stock institutions were required to have a minimum of 400 local stockholders with no one owning more than 10 percent of the stock. This fiduciary-beneficiary relationship helped restrain the entrepreneur from putting up $2 million to $3 million in new capital in a thrift only to cause FSLIC $400 million to $500 million in losses in three years. Whistle-blowing alternatives for dissenting officers, directors, and employees and dispersion of control are essential in cutting these huge, unsustainable losses.

Moreover, internal auditors with an effective reporting mechanism and adequate job security generally come into being only after the shock of substantial loss or potential loss. A credit review officer also often comes into existence only after revealed losses. Foresight in these two areas, with strict policy and procedural guidelines and meticulous minutes of meetings, will pay off handsomely in ensuring asset quality.

Put Your Credo Out Front

More generally, every thrift institution should be required to publish and post its mission statement. Many firms do this; hospitals, for example, post mission statements such as "dedicated to the preservation of the valuable gift of life." A thrift could be "dedicated to fulfilling the American dream of home ownership by encouraging the thrift necessary to fulfilling it." A thrift charter is a geographic franchise requiring those who possess one to use their financial and real estate expertise to serve profitably those markets where the institution has the ability to be a significant provider of those services. Commitment to accomplishing that mission could be demonstrated by a sign in the window: "Competitive enough to serve you. Dedicated and strong enough to protect you. Small and courteous enough to know you."

Whistle-blowing alternatives for dissenting officers, directors, and employees are essential

Trade organizations should devote more time to raising the quality of laws, regulations, education, training, and ethical standards. They should also be more vigilant in protecting their lobbying committees from being taken over by those with vested interests in laws and regulations that are counterproductive to the mission of the industry. The industry must have streetwise, professional regulators with the power to balance burdens and benefits and distribute them evenly. These regulators should be well paid and have job security.

How It Should Be Done

Long-range objectives should not be sacrificed for limited, short-term gains. Certainly we must adapt to change, but a steady course is far more desirable than the rudderless acceptance of rapid change for its own sake. The writer knows of two thrifts that could provide excellent suggestions on how to restructure the entire industry mechanism for balanced growth. These thrifts restructure a little bit every day, and they serve the public more efficiently every day. They use the law of large numbers to diversify their well-underwritten risk. Because almost all of their mortgages are monthly adjustable-rate loans, these thrifts nearly offset the interest rate risk on liabilities they must service with the earnings generated on the assets. Perpetuation of their thrift and the home-financing business is their game, and they have the asset-liability management and skilled employee mix to prove it. These two institutions have better long-term chances of survival because of their dedication to sound principles.

Balanced discipline will not come easily to the thrift industry; all the players push for a playing field that is unbalanced in their favor, and politicians are too much swayed by the media and public opinion. In the meantime, financial institutions are charged with providing a safe, accessible place for people to keep their money, obtain cash, and make third-party payments. Restraint on permissiveness is the only way out of our current malaise. Every responsible member of this industry should be outraged by the behavior of some operators who are, in effect, taking profits out of each institution's bottomline in the form of extra insurance premium assessments just because these operators are careless. The balanced chance of reasonable gain and risk of reasonable loss for all "vestees" is the only way to provide a semilevel playing field. ❑

EXHIBIT 3 (Page 2)

KEY INDICATORS OF FINANCIAL PERFORMANCE AND CONDITION
AS OF OR FOR 9 MONTHS ENDED 9/30/88 AS PREPARED BY KAPLAN AND SMITH
AND ASSOCIATES INC. FROM FHLB DATA

Grouping	No. of Assns.	Assets (Bil)	Net Interest Margin to TA	Regulatory Capital to Total Liabilities	Annualized Net Income 9 mo 1988 to Total Assets
USA	3045	$1,369	1.40%	4.07%	-0.88%
FHLB Dist 11	211	403	1.39	4.63	0.10
Retail Mtg Lenders (1-4 over 45% of TA)	69	168	1.93*	5.69*	0.52*
Wholesale Investors (MBS over 40% of TA)	17	74	0.67	3.19	-0.42
ADC Lenders (Acquisition & Dev over 30% TA)	11	7	-0.15	4.96	0.18
Specialized Lenders Consumer or multifamily loans over 30% TA	35	23	1.57*	5.55*	0.53*
Diversified Lenders meet none of above criteria	52	124	1.51*	5.84*	0.26*
Negative GAAP Net Worth (Self Explanatory)	27	7	-2.97	-22.29	-6.04

*Best Performers

TA - Total Assets

EXHIBIT 4

STATEMENT OF DAVID O. MAXWELL

CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF FANNIE MAE

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

MARCH 16, 1989

Mr. Chairman and Members of the Committee:

My name is David O. Maxwell. I am Chairman and Chief Executive Officer of the Federal National Mortgage Association. Fannie Mae is a privately-owned corporation with a public mandate to support homeownership. As its federal charter directs, Fannie Mae operates only in the secondary market in home mortgages for single- and multifamily loans. As a trade-off for this business restriction, the government maintains certain ties with the corporation that allow it to borrow at reduced cost. Fannie Mae passes its cost savings on to lenders and consumers in the form of lower interest rates on mortgages eligible for purchase by it and in the form of special, often-innovative, efforts to serve the housing credit needs of low or moderate income households.

I appreciate the opportunity to submit this statement on the Administration's proposed legislation (S. 413) to deal with the insolvent Federal Savings and Loan Insurance Corporation (FSLIC). A quick resolution of the FSLIC crisis is vital to stem added losses that would substantially increase the federal budget deficit and could further imperil confidence in the financial system. Both the Administration and this Committee have rendered a major service by moving so swiftly to contain the damage from past mistakes and misdeeds; to assure that they will not be repeated; and also to begin the process of restoring the thrift industry to its appropriate and useful place in the rapidly changing residential mortgage market.

My colleagues at Fannie Mae and I have followed the debate on the best way to resolve the FSLIC debacle and to prevent any recurrence. As one of the last witnesses to submit a statement at your hearings, there is hardly any information and not much weight of opinion that I can add to what you have already heard on many of the debated issues. These include such questions as how to apportion the necessary costs of making the FSLIC solvent, precisely how to reorganize the FSLIC and the FDIC, and where to lodge responsibility for chartering and supervising thrift institutions.

I therefore will focus my statement on two long-range issues on which my personal career experience and the central role of my company in the housing finance system may make my views of particular interest to the committee. These issues are (1) the importance of the thrift industry to housing; and (2) the need to maintain the independence of the borrowing and lending functions of the regional Home Loan Banks.

The Continuing Importance of the Thrift Industry to Housing

In recent years, electronic high-speed communication and powerful computers capable of rapidly collecting, analyzing and retrieving complex data have revolutionized the mortgage market, causing local housing credit to flow in the larger and swifter currents of regional, national and international credit of all types. The secondary mortgage market firms have both spurred and benefitted from this flow, becoming key participants in the American housing credit market.

However, the widest and deepest of rivers are fed by numerous springs and streams and similarly Fannie Mae and its sibling, the Federal Home Loan Mortgage Corporation (Freddie Mac), are dependent on thrift institutions, commercial banks and mortgage banking companies (including those which are subsidiaries of thrifts and banks) to provide them with a steady flow of home mortgages for their mortgage-backed securities (MBS) and their pools of portfolio investments. In addition, thrifts and increasingly, commercial banks, are major investors in MBS created by Fannie Mae and Freddie Mac.

The Interplay of the Primary and Secondary Markets

The housing finance system includes three basic components: mortgage originators, secondary market conduits, and investors in whole loans, MBS, and the debt securities of secondary market companies. By directly linking mortgage lenders, home buyers and capital markets, the secondary market assures maximum efficiency in delivery of home finance. It assures capital flows to all regions because it is a nationwide market; it attracts new investment capital to housing; and it lowers costs to home buyers.

With the secondary market as the "factory," delivery of mortgage funds to consumers has become a "high tech" industry. Originators in the primary market supply the raw material in the form of whole mortgages with a wide mix of terms and maturities. Fannie Mae and other firms then transform this illiquid product into highly liquid financial instruments with homogeneous features. In the final step, the secondary market firms market and distribute the finished product to a wide array of investors.

Home buyers garner the rewards of this efficiency by having assured access in all economic conditions to mortgage credit at the lowest possible rates. In effect, they are empowered to compete for funds with giant, multinational users of capital. The integration of the highly liquid mortgage securities market with the general capital markets also protects consumers from a cut-off of housing funds due to disintermediation. All of this has led the United States to a pre-eminent position in rates of homeownership.

The process of "manufacturing" MBS and providing a high-volume, liquid securities market for these instruments has become critical to successful delivery of home finance. Since the first MBS was issued in 1970, mortgage securities have become the preferred vehicle for mortgage funding. The percentage of originations of one- to four-family home mortgages pooled into agency mortgage-backed securities has increased from about four percent in 1973 to almost 40 percent in 1988. By the end of 1988, almost 40 percent of the outstanding residential mortgage debt of $2.2 trillion had been securitized. An additional five percent of outstanding residential mortgage debt is held in the portfolios of Fannie Mae and Freddie Mac.

MBS have been instrumental in enabling traditional lenders and prospective home buyers to cope in a deregulated environment. The rapid growth of MBS provided much needed flexibility to traditional lenders that had relied on short-term deposits to fund long-term fixed rate loans. Mortgage securitization gave them added access to liquidity and the means to make their mortgage lending operations less vulnerable to interest-rate risk.

By freeing lenders from relying too heavily on deposit flows and by attracting new investors, MBS have been vital to meeting the nationwide demand for home loans that has grown more rapidly than the deposit bases of traditional lenders in the deregulated environment.

Thrifts' Role in Origination of and Investment in Mortgages

The smooth functioning of the secondary market depends on mortgage originators and on investors in whole loans, MBS and the debt securities of secondary market companies.

Healthy thrifts continue to contribute importantly to home finance through their origination function and their investment in residential mortgages. Bank Board data show that despite widespread asset deregulation, most thrifts have remained committed to home mortgages. We estimate that thrift institutions originated $150 billion of single-family mortgages in 1988, increasing their share to 40 percent of all loans from 38 percent in 1987.

In addition to their origination role, thrifts remain important investors in mortgage debt. They hold 31 percent of all one- to four-unit loans, and about 38 percent of the multifamily mortgages outstanding. In dollar terms, the thrifts' investment of about $755 billion in residential mortgages at the end of September 1988 is over one and a half times the dollar investment of a decade ago. In addition to these holdings of whole loans, thrifts currently hold over $200 billion of MBS, about 27 percent of all MBS outstanding.

Equally important, thrifts' mortgage functions are quite profitable. Bank Board data demonstrate not only that thrifts have remained mortgage specialists, but that such commitment is the basis for business success. According to these studies, thrifts' performance varies directly with the size of holdings of home loans and MBS. As of September 1988, the portfolio composition of GAAP-solvent thrifts included a 64 percent investment in residential mortgage assets, while the GAAP-insolvent portion of the industry had only 49 percent of its investments in residential mortgage assets. Even more striking, the 532 thrifts with home loans and MBS equal to more than 75 percent of their assets had GAAP net worth of 6.3 percent, more than twice as high as those institutions with mortgage holdings equal to 50 to 60 percent of assets. Similarly, thrifts with mortgage holdings totalling 65 to 75 percent of assets had GAAP net worth one and a half times as high as the 50 to 60 percent group.

The Role of the Regional Home Loan Banks

Thrifts' historic commitment to mortgage origination and investment can be traced to certain incentives built into their statutory framework. One of the most important of these is access to reasonably-priced long-term funding through the twelve regional Home Loan Banks. This funding mechanism enables thrifts better to match their asset and liability maturities, as well as to contain costs. Access to Home Loan Bank funds is limited to institutions with a demonstrated portfolio commitment to home finance (generally, a 60 percent ratio of mortgage and mortgage-related assets to total assets). Although under the current system access is also limited (with minor exceptions) to thrifts, I believe the home finance delivery system as a whole would benefit if all financial depositories that met an appropriate "mortgage lender" portfolio test were permitted to use the system.

In my opinion, the Home Loan Banks in their role as providers of funds ought not to be treated as just another ministerial bureau in a federal department, but rather as a federally sponsored and regulated, business-oriented partner of the housing industry. I therefore recommend that the borrowing and lending functions of the twelve regional Home Loan Banks continue to function as a system outside any federal department.

To the extent that the Chairman of the Home Loan Bank System delegates supervisory or regulatory responsibilities to these banks, they should be managed on a day-to-day basis by him or her under the supervision of the Treasury Department. As to the borrowing and lending functions, however, the role of the executive branch of the federal government should, as is now the case, be limited to coordinated management of the banks. This could be done either through an administrator appointed by the President or a board whose chairman is a Presidential appointee. Certain major policies pursued by the banks which could materially impinge on the national economy or on the federal budget would be made subject to review and approval by the Secretary of the Treasury.

The breakdown now being dealt with by the Administration and by your Committee is centered in the FSLIC and in the failure adequately to supervise the deregulated savings and loan associations, whereas the borrowing and lending functions of the bank system do not appear to be in the need of fixing. At least some measure of agreement with this viewpoint may have been on Secretary Brady's mind when he testified on February 22, "that we

do not intend to micro-manage the revitalized Federal Home Loan Bank System."

It seems desirable also that the banking functions of the twelve privately-owned business-oriented regional banks not be placed in a position where they might even occasionally be subjected to micro-management by a subordinate of the Treasury Secretary. I come to this position not only as a participant in the housing credit market but from earlier experience in federal and state government.

From 1970 to 1973, I served as General Counsel of the Department of Housing and Urban Development. Prior to that, I served as Secretary of Administration and Budget and as Insurance Commissioner of the Commonwealth of Pennsylvania. In these positions I had many occasions to observe the pressures, or even obligations, that are quite properly imposed on administrators of subordinate governmental units to take full responsibility for everything that goes on within the four corners of the offices of which they are the titular chiefs.

It is too much to expect that the head of the unit labeled "FHL Bank System" or the superior unit labeled "FHLBS" on Chart I appended to Secretary Brady's testimony will refrain at all times from attempting to micro-manage all the activities -- including the banking activities -- of the twelve regional banks. At best there will be delays of days or weeks as policy and technical officials meet to discuss and debate the blurred lines that divide broad, narrow and micro-management. We know from Secretary Brady's testimony that such a result is not one intended by the Administration. Accordingly, I believe that it is not in the best interest either of the Treasury Department or of the thrift industry for them to be distracted in the future by a result unintended by the one and feared by the other.

The federal official charged with supervising or coordinating the banking functions of the twelve regional banks ought not to be swayed in his or her day-to-day work by considerations relating to short-range and shifting policies. However, truly major changes in the direction or scope of credit activities carried on by the Home Loan Banks should be subject to the Treasury Department's supervision just as Fannie Mae is now subject to certain regulatory controls both by the Treasury Department and by HUD.

The independence of the funding function of the Home Loan Banks is of enhanced significance because of the nature of the housing credit system. A home is the most expensive and the most interest-sensitive of all consumer commodities. The primary residential mortgage market is therefore one of the most volatile of all credit markets, and the secondary mortgage market (of which Fannie Mae is a part and the Home Loan Banks an adjunct) are more volatile still. The need to react speedily to constantly changing circumstances in the housing credit market reinforces the argument against placing the banking functions of the Home Loan Banks in what appears to be a fourth echelon unit of a government department.

Quick and reliable service by the banks is especially important today when the thrift institutions, as both owners and customers of the banks, are facing problems that range from survivability in the case of weaker lenders to sharply heightened competition for market share which has affected even the strongest of the leaders. Just in recent days, deposit outflows have made it essential for the Home Loan Banks to react promptly and effectively to thrifts' need for funds.

Conclusion: The Link Between S. 413 and National Housing Policy

During 1988, I had the privilege of serving as Vice Chairman of the National Housing Task Force under the leadership of James W. Rouse. In our report, A Decent Place to Live, we discussed both the importance of the thrift industry to housing and the sometimes fragile state of the housing market for low- and moderate-income households. Inefficiencies or inadequacies on the part of thrift institutions in serving the housing credit needs of a broad mid-range of income groups would have a domino effect both up and down the income scale as families who are already home owners drop out of the market for more expensive homes and yet other families who might buy vacated homes or modest new homes drop entirely out of the ownership market. At the extreme end of the continuum we have seen a sharp rise of homelessness even among the employed.

There are, however, parts of the housing finance market that are working well -- healthy thrifts, commercial banks and mortgage banks; the funding functions of the Home Loan Banks; and the secondary market, including Fannie Mae, Freddie Mac and Ginnie Mae. Both as Chairman of Fannie Mae and as a citizen vitally interested in preserving and expanding to all Americans the benefits of this country's position as the best housed in the world, I urge you to take special care in responding to today's FSLIC and budgetary problems in a manner that maintains the strength of these vital institutions.

PROBLEMS OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC]

PART IV OF IV

FRIDAY, MARCH 17, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Cranston, Dixon, Wirth, Bryan, D'Amato, Bond, Kassebaum, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome our witnesses today and others that are in attendance. We have a multitude of hearings underway on the Hill as I speak in other committees. We are beginning the markup of the budget in the Budget Committee, so Senator Sasser, who serves as the chairman of the Budget Committee, is necessarily at that markup this morning. I am also a member of that committee and at some point I may have to go to the committee.

We have a number of other important hearings going on in the Finance Committee and other places as well. So, we will have members coming and going in the course of the morning.

Let me make a few comments at the outset before we get to our witnesses.

This is our 18th and final day of hearings on the problems facing the thrift industry. Over the period of time of our hearings, we have heard from a wide variety of interested parties and witnesses.

We began with background testimony from experts that included, among others, the GAO and Mr. Paul Volcker. Immediately after the administration introduced its proposal and was prepared to testify, we heard from Treasury Secretary Brady, followed by the bank and thrift regulators as well as OMB Director Darman, and then again a panel of financial experts.

The past 7 days have been devoted for the most part to testimony from associations representing large and directly affected constituencies, including, among others, the banking industry, the thrift industry and other financial associations, the home builders, realtors, consumer groups, and State regulators.

I think it helps illustrate that on a problem of this dimension that there are very wide varieties of parties of interest, all of whom are directly affected and who need to be heard and have their views considered as we begin the process of now marking up and otherwise adjusting the administration's legislative package.

We have not had the legislative package for a very long period of time because it was very complicated for the administration to put into actual legislative language. The bill itself runs 333 pages and each word and each line is important. As anyone knows who's been involved in writing legislation, you can have 332 pages that are properly written and one page that's improperly written and the whole package can be flawed in a way that it can't work properly.

So, we are giving very careful attention to each and every aspect of the package and working on it literally seven days a week.

We have previously announced a timetable in the last 2 days. I will not recount that here except to say that we are going to a flat-out schedule to prepare the committee print, take it to markup here in the committee, and seek an immediate time slot on the floor. We hope to have it on the Senate floor and intend to have it on the Senate floor for final action in the period of April 18 to the 21.

In the days between now and then, there are a number of formal reporting requirements that apply once we have reached a certain step. A certain number of days has to elapse in order to allow the printing and the distribution of materials to colleagues not on the Banking Committee so they are in a position to understand what is in the legislative proposal and to make their own judgments.

In any event, in a problem of this unprecedented size, complexity, and dimension, it's very important that while we work quickly, we do the job properly. This is a problem that very little attention was paid to by the Reagan administration. Since the problem has come to light and to the very intense interest of the new administration, things have been moving at a much faster rate. We will move this legislation out of here as quickly as we can consistent with the task of being confident that we've done it right.

With $100 billion having been squandered in a variety of ways and for a variety of reasons, this chairman is very sensitive to the requirement that the package we develop is sound enough that we can prevent a future catastrophic systems failure.

And so that is the standard to which we are working and we will continue to work.

Today's final witnesses very much exemplify the approach we have taken to try to assemble all of the facts and the relevant body of opinion so that we can make the judgments that are required.

Today we have three witnesses who represent quite different points of view as to how we should see the future of the savings and loan industry in this country. We have three practitioners that are operating in different ways and importantly different ways.

On the one hand, we have what might be called a traditional savings and loan association, headed by Mr. Herb Sandler, who is the chairman of the World Savings and Loan based in Oakland, CA.

Then we have also, representing a less traditional more diversified thrift viewpoint, Mr. Ernest Fleischer, who is the chairman of the Franklin Savings Association from Ottawa, KS.

And our third panelist is Mr. Lewis Ranieri, who has devoted his career to housing finance and was a guiding innovator of the mortgage-backed security concept. He also now finds himself in the savings and loan business and currently heads his own firm, Ranieri Wilson based in New York City.

I believe the testimony this morning will help crystalize and summarize for the committee some of the conflicting issues that we must resolve as we move from the hearing stage to drafting the markup vehicle and then ultimately passage of final legislation on the Senate floor.

After we have heard summary comments from each of the three witnesses, I will do something we haven't done before. I will give each witness an opportunity to reflect aloud on what they have heard the other two witnesses say so that we can get something of an exchange back and forth between those at the table before we move on to questions from Senators.

With that, let me now ask my colleagues if they have any opening comments they would like to make. Senator Cranston.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. Thank you very much, Don. I'm eager to hear the witnesses so I won't go on at any length, but I do want to welcome an outstanding constituent, Herb Sandler, who's been very successful in this realm and his advice should be a great benefit to us, and also Lew Ranieri who I've known for a long time and is doing some very interesting things also in this field, and I'm eager to hear from him, and I welcome you also, Mr. Fleischer. It's a great pleasure to have you with us.

I am particularly eager to hear the interchange between you and I hope that can really be free-flowing so you can comment back and forth.

The CHAIRMAN. Thank you, Senator Cranston.

Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you very much, Mr. Chairman.

I would also welcome all three panelists, all of whom I've known and worked with in the past. I appreciate your being here.

Just as an opening note, Mr. Chairman, I saw with interest the speech that the President gave yesterday in Texas urging the Congress to act rapidly on the S&L crisis and on the legislation that they have set up.

I had two reactions to that. One, I was very proud of the work that you have done and the speed with which the committee has operated and the intensity of the hearings that we have had bemoaned by many because there have been so many and it's been such a good operation, but I think absolutely essential. I think we have moved very rapidly on this after the issue had been out there for such a long period of time and nothing happening from the administration and we finally got a proposal from them.

I hope that the President's statement in Texas is not the opening shot of something that might come from the administration suggesting that somehow problems in the S&L world are the result of the Congress not passing their legislation overnight. I think I can see that kind of 30-second bite coming out of the administration and I would just hope that we don't see that.

This morning I hope, Mr. Chairman, in particular we might have the three panelists address themselves to the thorny issue of State powers in particular. I am very interested in that and where the State powers should stop and Federal restrictions ought to pick up, and I hope that as we hear from each of them and as there is debate and discussion back and forth that we might be able to hear a consensus on that front.

Mr. Chairman, thank you very much.

The CHAIRMAN. Thank you, Senator Wirth.

I was also struck by another story in the morning paper that I don't have in front of me now. I'm asking someone to get it. It was a speech that the Vice President gave yesterday and in the course of his remarks he made the observation that when the Congress hurries it usually gets it wrong. He was also reflecting that on administrations as well. It was a commentary on whether or not the administration was in fact moving quickly. So, we had the interesting observations by both the President and the Vice President on that subject yesterday that seemed to cutting in opposite directions.

Senator WIRTH. Well, you're doing it right, Mr. Chairman.

The CHAIRMAN. Before we begin hearing from our witnesses, I have statements from Senators Dixon and Shelby to be inserted in the record.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr Chairman, I am very pleased to be here this morning as the Senate Banking Committee concludes its hearing on the problems of the thrift industry. I look forward to hearing the testimony of various executives from the thrift industry, Herb Sandler, Ernest Fleischer, and Lewis Ranieri.

Today is the eighteenth hearing which the Banking Committee has held over the past 6 weeks—with no less than 12 of these hearings held over the past 3 weeks. That is a highly demanding schedule, but an appropriate one given the gravity and urgency of the legislation we are considering.

Yesterday the chairman announced the committee's schedule for this legislation. It is an ambitious schedule, a demanding schedule, and again an appropriate one. I intend to do everything I can so that we can meet it.

One stage of the committee's work concludes today, and another stage begins. As we review the language of the administration's reform, recovery and enforcement legislative proposal, as we mark up this bill, we will be making important budgetary and regulatory decisions. We have a good bill to work with, but in some areas I believe we can make improvements. I look forward to working with the other committee members to produce the best legislation we can, according to the chairman's announced schedule.

Thank you, Mr. Chairman.

STATEMENT BY SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I would like to congratulate you for scheduling an excellent set of hearings over the past several weeks. Almost all participants in this debate have had an opportunity to testify and I think we have gained important insight into the ramifications of the administration's proposal.

Today's testimony is equally insightful. Today's witnesses provide a different perspective of the industry's future and make some interesting suggestions. I appreciate your candor and constructive criticism of the Bush proposal.

I agree with the recurrent theme in your statements; we cannot legislate a solution that puts the future viability of the thrift industry in jeopardy. Having made the decision that a separately chartered, separately regulated industry charged with housing finance is desirable, it is contradictory to then tax and assess the industry to the point of insolvency. The administration's proposal assesses the industry directly and indirectly, to the fullest extent possible.

However, I have not been convinced that this plan will assess the industry into insolvency. Healthy thrifts argue that taxes such as this are inequitable and they are right. However, it is no less inequitable to present the taxpayers with a $100 billion-plus bill. Thrifts do bear the responsibility of their silent complicity and it is appropriate that they must share in the clean up. It may be necessary, however, to incorporate more flexibility into the proposal to ensure that the scheduled assessments can be paid.

Most of the industry representatives that I have met with recently have indicated that the insurance assessment, while steep, is possible. These thrifts, however, are less certain, indeed quite concerned, over the requirement of 6 percent capital by mid-1991. I share this concern.

The solvent sector of the S&L industry will need to attract somewhere between $25 and $40 billion in order to meet the new capital requirement. This money can come from one of four places: Earnings, outside capital, shrinking the balance sheet, and consolidation.

It is my understanding that the industry can expect no more than $7.3 billion in earnings in the 2½ years before the 1991 target date. Attracting outside captal will not be easy. Healthy stock S&L's may be able to attract about $5 billion in capital before 1991 and mutuals may be able to raise $2 billion more. However, the attractiveness of thrifts to would-be investors diminishes with each additional levy on earnings.

While I support giving the insurance fund the flexibility to raise premiums, the potential for a 35 basis point premium represents a potential drain on dividends for would-be investors and will reduce the attractiveness of the S&L stock as an investment.

Most of the thrifts in my State that cannot meet the trigger date will either have to shrink or merge. However, troubled institutions will probably be unable to sell assets without incurring losses. If a thrift is undercapitalized, chances are that the market value of many assets is below that of book. Thus shrinking is not the easy option for troubled thrifts that some would have you believe.

Consolidation will be inevitable and indeed, to some extent, desirable. The present crisis indicates that there exists an overcapacity in the marketplace, as too many institutions drive up the cost of funds and bring down the spreads earned. Over the next few years, we can anticipate well-capitalized financial institutions taking advantage of the opportunity to broaden their customer base and achieve administrative and economic efficiencies by purchasing insufficiently capitalized institutions.

However, the downside of consoldiation is concentration. Although the fewer competitors that remain will be able to price sufficiently to cover costs, costs for consumers will rise. The cost of homeownership can be expected to increase and there will be a corresponding impact on the economy.

The dynamics of the marketplace will not be changed by this or any legislation. Economic forces will always act as the man behind the curtain, guiding the actions of the participants and the flows of capital in the financial services industry. Government intervention is only warranted when it is necessary to promote a desirable social good that would not be available in sufficient quantity without such intervention. The Housing Act of 1949 establishes housing as such a good and we today raffirm that statement.

Thus it is essential that we act responsibly as we resolve this crisis. I am a cosponsor of the administration's legislation because I have believed from the outset that it is a viable, blueprint that can work. At the end of 18 hearings, I still believe that this proposal is a good one. I do, however, believe that we can make it better and I look forward to working on the details in the upcoming weeks. We have a chance to be effective and I am confident that we will succeed.

Mr. Chairman, you have scheduled an excellent set of hearings and have proposed an ambitious timetable for this measure's completion. I commend your leadership as well as the spirit of cooperation with which you have embraced this proposal.

Thank you, Mr. Chairman.

The CHAIRMAN. I want to also say before we call our first witness that with the conclusion of the formal hearing process today, we are actively now at work in drafting modifications and adjustments to the administration package which members will take up and resolve into a formal committee print. So, any other party at interest that has a compelling observation to make or suggestion that they want to have us consider, it would be very well for them to get that information to us if they have not already.

I want to cite one quotation that I made earlier from the Vice President yesterday where he said, "Quick fixes are often bad fixes." And that was in the context of let's not go too fast, let's make sure we know what we're doing so we do it right.

In any case, Mr. Sandler, we would be pleased to hear from you. I have introduced all three of our witnesses earlier in terms of their backgrounds, so we will go in order across the table hearing from you first, Mr. Sandler.

STATEMENT OF HERBERT M. SANDLER, CHAIRMAN AND CEO, WORLD SAVINGS AND LOAN ASSOCIATION, OAKLAND, CA, ACCOMPANIED BY MARION SANDLER

Mr. SANDLER. Thank you, Senator.

Mr. Chairman and Senators, I would like you to look very, very closely at me because what you see is a member of an endangered species. I am a member of the species called by some "thriftus traditionalus," a traditional thrift. There are approximately 2,000 of us. We make primarily residential loans. We are well capitalized and we are honestly and prudently operated. Many of us are quiet citizens, not particularly active in trade association activities. Some of us have been noisy and obnoxious fighting the high-flyers and crooks that entered and raped our industry in the early 1980's, fighting misguided and foolish trade association policies, fighting misguided and foolish administration and congressional policies, fighting unbelievable regulatory ineptitude and supervisory incompetence, all in large part in vain.

Mr. Chairman and Senators, I'm sure that the members of the administration who crafted this proposal are honorable men, but, Mr. Chairman, as a member of an endangered species, as a student of the thrift industry, and frankly subjecting myself to charges of hubris, one who has predicted almost without error everything that has happened to the thrift industry and FSLIC in the last 10 years, I am here to tell you that if the administration had intended to weaken, dismember, or destroy the thrift industry and the Federal Home-Loan Bank System, the heart of the mortgage finance system that has done the best job of housing its citizens of any country in history, and if the administration had wanted to do so while obscuring from the Congress and the public what was really going on, they could not have gone about it in a more effective way. As I said, they are honorable men.

Before I explain the way the plan works, let's make clear where I'm coming from.

One, thrifts should be focused on housing. Two, adequate real capital must be a requirement, not an option. The stench of capital forbearance is in the air and if you succumb to it that will be the single biggest error you will make and you will be directly responsible for the next and inevitable disaster—FSLIC II, Son of FSLIC, or whatever.

Our written testimony provides a balanced approach to the capital issue taking into account the legitimate concerns about fairness.

And the third item is we must have tougher, smarter, more gutsy supervision.

Now let's turn now to this unbelievably complex proposal. Mr. Chairman and Senators, this is not the wiring system of the space ship Discovery. It's not a Rube Goldberg approach to solving the Third World debt crisis, the Middle East problems, and the disarmament process. This is the administration's financing proposal.

Now based on 26 years as a CEO of an extremely successful company, one thing I've learned is that the more simple a plan or program is, the more likely it will work, the more likely that there will not be hidden or unexpected catastrophes lurking. Complexity is a warning signal. Bells go off.

I guarantee to you no one—no one—understands the full interaction or implications of this extraordinarily complex scheme with funds floating in turn from and to one place or another. No one understands how it will really work, what it will do, what its impact will be, and what hidden flaws will blindside Congress and the administration and the financial system of this country and create the next disaster.

Simple solutions have a much better chance of working and we have suggested in our written paper some modifications which simplify the proposal, increases its fairness, is virtually certain to be free of the threat of the hidden disasters, has a high probability of success, and will bring an end to the fears that permeate the atmosphere.

Let's see how the administration plan works or doesn't work. You will notice we have four pails on the table. The big red pail is the FSLIC hole that has to be filled and it's labeled "The FSLIC Disaster." Please note that this pail is empty. It's true to life. It needs in excess of $100 billion.

The tan pail is the new savings and loan insurance fund. That, too, is empty and the plan requires that we fill that hole also until it has enough money to equal 1.2 percent of our deposits, as we should. We call that pail the "New FSLIC Fund."

The third pail, or the first blue pail, is another hole we have to fill. That's the S&L capital hole. That pail is approximately 60 percent full, but it needs about another $25 to $35 billion more to get it where it has to be for GAAP solvent companies.

A brief digression. It is critically important to fill that pail to overflowing because, one, real capital is a protection or buffer before FSLIC or the public has to take losses; two, experience shows that when companies have real capital at stake they usually behave more prudently; and three, real capital protects the company itself during hard times.

The last pail, the second blue pail, is the earnings pail. This has to be filled by us every year from such things as interest earned on loans, plus dividends on Federal Home Loan Bank stock, minus interest paid on savings and the cost of operations, which include the usual expenses and insurance premiums.

Now you may be wondering what those blocks are in front of the pails. All the blocks on the table represent the GAAP solvent S&L companies. Those closest to the edge of the table, closest to you, have the lowest capital. Those furthest from the edge are the strongest.

Now let's take a hypothetical but prototypical company and let's assume it earns in 1990 75 basis points on its assets. In the business we call this ROA, return on assets. And 75 basis points is a very good result, higher in fact than the average bank or savings and loan achieved over the last 5 years. And we will assume that the 75 basis point return on assets comes after the institution pays an insurance premium of 15 basis points, which is the highest premium banks are ever scheduled to pay under the proposal.

Now, Marion, would you please put 75 basis points into the earnings pail. Thank you. Now let's see what happens under the administration's proposal. Marion, would you please pour all your earnings into the S&L capital pail. Wait a minute, you only paid 15 basis points insurance premiums, just like the nice banks, the ones who made the Third World loans and the energy loans. That's just not enough. We're going to punish you because you were a member of the U.S. League in the early 1980's and you've got to pay higher premiums. Now I know you've already paid $5 billion extra already, but the administration proposal says you've got to pay a higher premium.

Marion, please reduce your capital by the amount of the extra premium. Thank you. Now wait just another minute. You've got to reduce your capital some more. Your income included dividends on the Federal Home Loan Bank stock that you are required to keep by law, but you forgot we just took $2 billion out of the Federal Home Loan Bank System and in fact we are going to take another $300 million a year for at least the next 30 years. So your Federal Home Loan Bank dividends are much, much lower. So, Marion, you're going to have to take some more out of the S&L capital pail. Gee, it's getting lower rather than higher.

I guess that does it. Just a second, Marion. Would you please look at the new FSLIC fund pail. Do you have 1.2 percent of deposits there?

Mrs. SANDLER. No.

Mr. SANDLER. Well, then take out some more S&L capital until you have increased your premium to 35 basis points.

Now, Mr. Chairman, what's the effect of these extra costs? Strong companies will become medium strength companies. Medium strength companies will become weak companies. And weak companies—well, Marion, why don't you show them what happens. That's right. They become insolvent and they push all the others that much closer to the edge.

Notice also, Mr. Chairman and Senators, that there are now fewer institutions left to pay the insurance premiums and think about the implications of that. Now we could repeat the process if you wanted to give me the time to do so for additional years, but it would look very much the same, only there would be fewer and fewer companies and weaker and weaker companies and less and less companies to pay the premiums or to make home loans.

What does it all mean? Just dealing with the predictable and obvious interactions of the administration's proposal complex and burdensome features and excluding the high likelihood of a hidden or latent catastrophe that lurks in the administration proposal, the following takes place.

One, S&L earnings will be lower. Two, capital will be lower and this in fact is one of the greatest anomalies of the administration plan—a built-in Catch-22—the administration wants—not wants—the administration demands and correctly that capital be increased through earnings or by attracting outside capital. And yet the very proposal itself, by its own terms, defeats any possibility of increasing capital.

Capital cannot be built from earnings because the proposal mandates a reduction in earnings due to: One, a high basic premium; two, lower earnings on Federal Home Loan Bank stock; three, probably increased cost of borrowing from the Federal Home Loan

Banks, which I haven't had time to discuss; four, the probability of further increase of premiums to 35 basis points, excluding the extraordinary, permanent competitive advantage given to banks.

Well, then, if you can't increase capital from earnings, why not sell stock to the public or sell the company to heavily capitalized companies? Would anyone in his or her right mind make an investment in an industry where the returns on the investment are guaranteed to be much lower than returns in other industries and probably lower than are CD rates? Would anyone in his or her right mind make an investment in an industry in which a regulator, an appointed official, can confiscate your earnings, take your capital, and actually have a permanent call on your entire investment no matter how prudently, honestly, or how well your company is operated, no matter how highly capitalized, no matter how profitable? Not on your life.

The administration proposal in its current form will accomplish the precise opposite of its stated intentions. It will kill the industry. It will kill the Federal Home Loan Bank System. It will dislocate the home finance system and it will cause mortgage rates to rise.

Thank you.

[The summary and complete prepared statement of Herbert M. Sandler follow:]

WRITTEN TESTIMONY OF HERBERT M. SANDLER
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
OF WORLD SAVINGS AND LOAN ASSOCIATION
BEFORE THE
U.S. SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

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WRITTEN TESTIMONY OF HERBERT M. SANDLER,

CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF WORLD SAVINGS AND LOAN ASSOCIATION

BEFORE THE

U.S. SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

MARCH 17, 1989

In the interest of getting to the point very quickly, this paper will not waste time on the obvious political niceties of complimenting the Bush Administration for recognizing that a major problem exists in the financial system. Furthermore, it is difficult to work up much enthusiasm for a proposal that has serious hidden defects and could very well lead to the demise of the savings and loan industry and destroy a functioning housing finance system. In point of fact, the plan is so flawed that reasonable observers can only wonder in amazement why it is, as the Wall Street Journal put it on March 10, 1989, that the Proposal is "sailing through an obliging Congress."

By way of background, it should be remembered that the Proposal was patched together in great haste and within the following context:

- Impose no new taxes
- Obfuscate the budget impact
- Avoid triggering Gramm Rudman
- Create a climate in which it can be said that the savings and loan industry is suffering great "pain" (despite the fact that many S&Ls which caused the losses are already gone and those which are to endure "pain" are innocent victims)
- Keep other "interest" groups, such as banks, at bay.

As a result, the Proposal is complex and hard to understand. It is particularly difficult to know how the various parts fit and the results of their interaction. What money from what sources go to what fund for what purpose? Will the funds be adequate? Are the underlying assumptions at least reasonable? What if the assumptions are wrong?

Why then is a flawed proposal "sailing through an obliging Congress?" There are several reasons:

- Almost everyone is grateful to the Administration for acknowledging that there is a financial disaster of extraordinary proportions.
- The Proposal contemplates providing funds to put brain dead institutions, which have been distorting the markets and increasing losses, out of their misery.
- The very complexity of the Proposal makes it difficult for anyone but the most sophisticated analyst to understand the extraordinary and inevitable impact: to wit, the weakening and ultimate elimination of the FHLB System and the savings and loan industry, with its inevitable impact on mortgage finance and home ownership in this country.
- Most "interested" parties have focused on the surface issues, "parochial" concerns and individual aspects of the Proposal, without sifting through the extraordinary complexities and seeing how the pieces fit together and the impact of this interaction.

Within the limited time frame available, this paper attempts to delineate and analyze the flaws of the Proposal, how the parts interact and the inevitable consequences. The paper also suggests needed alterations, which will strengthen the likelihood of achieving two of the President's stated objectives: namely the survival of the Federal Home Loan Bank System and of the thrift industry to serve home finance.

I. PAYING FOR THE U.S. GOVERNMENT'S DEPOSIT INSURANCE OBLIGATION: THE REAL BURDEN OF THE PROPOSAL ON THRIFTS

The Administration Proposal Imposes Destructive Hidden Taxes on the Savings and Loan Industry.

Merely as a point of reference, it may be instructive to look at the data which shows insurance premiums before the Administration Proposal and the stated level of assessments after.

Table 1
S&L Insurance Premiums
Expressed in Basis Points(a)
and Dollars per $1000 of Deposits
1984-1994

Year Ended	Basis Points(a)	Cost per $1000 of Deposits
1984	8.3	$ .83
1985-1990(b)	20.8	2.08
1991-1993(c)	23.0	2.30
1994(c)	18.0	1.80

(a) A basis point is one one-hundredth of a percent.
(b) Beginning in 1985 the Federal Savings and Loan Insurance Corporation assessed a special 1/8 of one percent (12.5 basis points) on top of the regular 1/12 of one percent (8.3 basis points) premium.
(c) Administration Proposal.

If the Proposal were as straightforward as the above numbers suggest, then it would be relatively simple to evaluate its long-term effect. But unhappily, there are two often overlooked land mines that could very well condemn healthy thrifts to decades of mediocre performance and bring about the demise of currently weak companies.

- **The blank check.** If the ratio of reserves to insured deposits is less than 1.2 percent, which will be the case under the Proposal for many years, the insurance agency could increase premiums to a level as high as $3.50 per $1000 of deposits (35 basis points) to restore the ratio to 1.2 percent. Furthermore, the Proposal does not stop there. The rate could be set at a level in excess of 35 basis points to cover actual incurred losses of the agency.

Savings and loan deposit insurance premiums almost assuredly will be increased quickly to 35 basis points. This premium increase will occur because the Proposal authorizes the Federal Deposit Insurance Corporation (FDIC) to increase the premium to 35 basis points whenever the ratio of Savings Association Insurance Fund (SAIF) assets to total savings and loan deposits is less than 1.2%. SAIF will be far short of the 1.2% ratio for many years into the future because SAIF is the new savings and loan deposit insurance fund that starts with no assets and is to be capitalized primarily from thrift deposit premiums. But, the Financing Corporation (FICO), the Resolution Funding Corporation (RFC), and the FSLIC Resolution Fund[1] all have a prior call on those thrift deposit insurance premiums, so SAIF premium receipts will be modest. The inadequacy of thrift deposit premiums to fund all four entities, SAIF, FICO, RTC, and the FSLIC Resolution Fund, as required by the Proposal, is made even more obvious considering two other facts. First, the amount of thrift deposit premiums the Proposal contemplates for the RTC and the FSLIC Resolution Fund to resolve failed companies is premised on interest rates being as low as 4% by 1994. Second, the amount of savings and loan deposit insurance premiums projected to be available is premised on a 7.2% annual deposit increase. Given the growth constraints that arise from the Proposal's capital requirements, that rate of deposit growth could well be optimistic.

The expropriation of the Federal Home Loan Bank System. When the infamous criminal Willie Sutton was asked why he robbed banks, his answer was said to be "Because that's where the money is." While it may be unflattering to analogize the Proposal's approach to Sutton's, the Administration seems to be walking down the same path.

Short-term considerations such as campaign promises and current deficits have perhaps obscured the longer-term, costly, self-defeating effects of the attack on the integrity and coffers of the Federal Home Loan Bank System.

With its Proposal, the Administration has initiated an unprecedented approach in American public policy. An industry that has played a vital role in providing home financing to the American people and which, despite recent assertions by some to the contrary, can continue to play that role, would see hidden taxes eat away important profits--profits vital to rebuilding the industry's capital and providing a sound basis for future economical residential lending.

The First Tax: The Damaging Premium Increase

To put the deposit premium issue in perspective, Table 2 shows the average annual dollar cost, compared with 1988, to be borne by the industry, for both the proposed new standard deposit premium (Table 1, page 3) and the 35 basis point premium option.

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[1] See page 39 for an explanation of these entities.

Table 2

Impact of Administration Proposal
For Thrift Deposit Premiums
on GAAP-Solvent Thrift(a) Income

(Dollars in Millions)

		Annual Average Cost 1989-1993	
		Standard Premium	35 Basis Point Premium
Increase in Deposit Premium Compared with 1988	Amount:	$ 119	$ 965
	Cost of Foregone Earnings:	23	224
	Total	$ 142	$1,189
Total as a % of Deposits (in basis points)		2	14
Total as a % of 1988 GAAP-Solvent S&L Earnings		2%	20%

(a) Thrifts insured by FSLIC with net worth, as measured by Generally Accepted Accounting Principles, greater than $0.

Table 2 shows that, while the impact of the proposed, new standard premium would be comparatively small, the imposition of a 35 basis point deposit premium would have a sizeable impact on the earnings of GAAP-solvent thrifts. By way of comparison, the 35 basis point premium would have reduced the 1988 profit of GAAP-solvent savings and loans by an estimated 20%.

The Second Tax: The Administration Proposal Would Indirectly Tax the Savings and Loan Industry by Expropriating the Industry's Investment in the Federal Home Loan Banks.

All FSLIC-insured thrifts are members of the Federal Home Loan Banks which have a vital role to play in the survival of the industry. Yet, the Administration proposes to raid the Federal Home Loan Banks--and thus its thrift members--by confiscating part of the capital and future earnings of the Federal Home Loan Banks (FHLBs, FHLBanks or Banks). Since the consequences of these acts are both far reaching and little understood, it is important to first, establish a context for the ensuing discussion, and second, spell out the deleterious effect of that part of the Administration Plan dealing with the Federal Home Loan Banks.

The Federal Home Loan Banks were established by the Federal Home Loan Bank Act of 1932 to make secured borrowings, also called "advances," to creditworthy members in furtherance of their housing finance mission. Since each FSLIC-insured institution is required to purchase stock in its District Bank[1], the FHLBs are literally owned by the thrift industry.

Advances to members to finance real estate lending is the primary source of earnings for the FHLBs. Over the years, a portion of these profits has been paid out to members in dividends as a return on their investment, and the remainder retained by the Banks to build capital. Dividend income is often an important part of member income. For example, in 1988, dividends of $1.2 billion represented at least 25% of the profits of the GAAP-solvent portion of the industry. The FHLBs also provide balance sheet strength, since each thrift's *pro rata* share of the District Bank's paid-in capital is obviously included in a company's net worth. (See Appendices 1 and 2 for further detail on the Federal Home Loan Bank System).

Back to Willie Sutton. The Administration covets both the retained earnings and the future profits of the FHLBanks. The Proposal would impose an approximately $2 billion assessment (over 3 years) against the retained earnings of the 12 FHLBs, as well as an additional annual assessment of $300 million from future earnings for at least 30 years.

This drain would result initially in a significant dramatic curtailment of dividends to FHLBank members, and therefore a substantial reduction in income of thrift institutions in the short run. Over the longer term, industry earnings would continue to be negatively impacted, although in a less dramatic fashion than in the first three years.

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[1] The U.S. is divided into 12 geographical districts.

Table 3, which follows, quantifies the impact of expropriating the retained and future earnings of the FHLBanks on the savings and loan industry. An outstanding issue which will affect the ultimate magnitude of the cost to thrifts is how the FHLBanks will be required to account for their contribution from retained earnings. On the one hand, if the contribution of the FHLBanks' existing retained earnings is treated as an investment in RFC, similar to the FHLBanks' previous purchase of FICO stock, the impact on the FHLBanks' income statement will be limited to the foregone earnings on their contribution. On the other hand, if the Banks are required to write off their contribution from retained earnings as a non-interest expense, the contribution will come directly out of the current earnings of the FHLBanks and consequently will lower dividends to members even more substantially.

Table 3

Impact of Administration Proposal to Expropriate FHLB Retained and Future Earnings On GAAP-Solvent Thrift(a) Income

(Dollars in Millions)

		Annual Average Cost 1989-1993	
		Expropriation of FHLB Retained Earnings Not Expensed	Expropriation of FHLB Retained Earnings Expensed
Expropriation of FHLB Retained Earnings (b):	Amount:	$ 0	$ 460
	Cost of Foregone Earnings:	191	191
	Total	$ 191	$ 651
Expropriation of FHLB Current Earnings (c):	Annual Amount:	$ 300	$ 300
	Cost of Foregone Earnings:	91	91
	Total	$ 391	$ 391
	Total	$ 582	$1,042
Total as % of Deposits (in basis points)		7	12
Total as % of 1988 GAAP-Solvent S&L Earnings		10%	18%
Total as % of 1988 FHLB Dividend		49%	87%

(a) Thrifts insured by FSLIC with net worth, as measured by Generally Accepted Accounting Principles, greater than $0.
(b) Approximately $2.0 billion over a three year period.
(c) $300 million per year.

Table 3 shows that over the next five years, the smaller dividends due to the expropriation of capital and earnings from the FHLBanks, will result in significantly lower income for the thrift industry. Compared with 1988, the likely FHLBank dividend reduction would be equivalent to a 10% to 18% after-tax haircut in annual income for the industry's solvent segment, depending on certain accounting decisions[1]. Again, the cost imposed by this element of the Administration Proposal would bleed the industry's healthy component while preventing weaker companies from realistically strengthening their position.

In addition, a reduction in dividends would make membership and investment in the FHLBanks substantially less attractive. Approximately one fourth of the FHLBanks' capital stock represents a voluntary investment by their members. Common sense suggests that a significant portion of that voluntary stock investment would be redeemed as a result of the scenario created by the Administration Proposal. Thus, the FHLBanks could lose a very high proportion of their capital under the proposed legislation. Reduced capitalization and the possibility of increased credit risk exposure of the FHLBanks (arising partly from Administration efforts to use the Banks to make liquidity loans on bad collateral to failed thrifts) could weaken investor confidence in the debt obligations[2] of the FHLBanks, thereby increasing the financing costs of the FHLBanks, and consequently, increasing the borrowing costs for thrifts (and ultimately the home-buying public).

The Proposal's Cost Wounds the Thrift Industry

Regardless of the professed intention of the Administration to preserve the savings and loan industry, any thoughtful evaluation of the Proposal's heavy burden placed on S&Ls reveals that the Proposal's cost severely threatens the thrift business.

Table 4, which follows, sets forth the impact of the higher thrift deposit premiums combined with the expropriation of earnings from the Federal Home Loan Bank System. On the low side, with the new, proposed standard deposit premiums and favorable accounting for the expropriation of the FHLBanks' retained earnings, the total cost amounts to the equivalent of a 9 basis point increase in deposit premiums compared with 1988 (and a 14 basis point increase compared to long-term bank premiums). An effective tax of this magnitude makes a noticeable cut in the profits of the healthy portion of the industry. At the high end, with a 35 basis point premium, and with or without unfavorable FHLBank accounting, these taxes would have reduced the 1988 earnings of GAAP-solvent thrifts by one-third on an after-tax basis.

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[1] Accounting for the expropriation of the FHLBanks' retained earnings is important, but the economic reality, regardless of accounting treatment, is that those retained earnings basically are lost to the FHLBanks under the Proposal.

[2] FHLBanks depend upon the capital markets for funds to make advances.

Superficially, it would appear that the industry in aggregate could support the loss of income caused by these taxes. However, the ramifications of lower profits are far reaching: 1988's strong healthy companies would report mediocre results; middling companies would turn marginal; and today's weak associations would probably not survive. At the same time (and as discussed more fully in the section on capital beginning on page 12), the industry vitally needs to build capital, a task which would be thwarted by the costs imposed by the Proposal. Without the ability to earn well and to increase their capital base, thrifts' ability to perform their central role in support of homeownership will certainly be materially curtailed.

Table 4

Total Impact of Administration Proposal on GAAP-Solvent Thrift(a) Income

(Dollars in Millions)

	Average Annual Cost 1989-1993			
	Expropriation of FHLB Retained Earnings Not Expensed		Expropriation of FHLB Retained Earnings Expensed	
	Standard Deposit Premium	35 BP Deposit Premium	Standard Deposit Premium	35 BP Deposit Premium
Cost of Thrift Deposit Premium Compared with 1988	$ 142	$1,189	$ 142	$1,189
Cost of Expropriating FHLB Retained and Future Earnings	582	582	1,042	1,042
Total Cost	$ 724	$1,771	$1,184	$2,231
Total as a % of Deposits (in basis points)	9	21	14	26
Total as a % of 1988 GAAP-Solvent S&L Earnings	12%	30%	20%	38%

(a) Thrifts insured by FSLIC with net worth, as measured by Generally Accepted Accounting Principles, greater than $0.

The Administration Proposal Is Inconsistent With Requirements to Increase Capital.

An important element of the Administration Proposal is the recommendation for higher capital levels. Capital serves several functions in a financial institution, including:

1. Providing a cushion against adverse operating environments. Higher capital will lessen the call on the insurance fund in the event of losses by associations in the future.
2. Providing a greater stake in the effective management of companies by their owners, thereby helping to limit the amount of risky undertakings.
3. Providing a boost to profits, in the case of common stock and retained earnings, since the association pays no interest on these funds.

The Proposal requires that thrifts meet the same capital standards as national banks by June, 1991, two and one-quarter years from now. In a nutshell, it appears that national banks will be required to have capital equal either to 8% of risk adjusted assets (4% of which must be primary or true capital such as equity) or 6% of total assets. This will be a very difficult challenge in such a short time period for many prudently operated, healthy thrifts.

To put the issue of need for capital formation within the context of the savings and loan industry, Table 5 sets forth the number of FSLIC-insured institutions and assets held by those institutions by level of capitalization as of September 30, 1988. Table 5 shows that, while the highest net worth ratio category (6% or over) included 40% of the nation's associations, only slightly more than 20% of the assets were held by these highly capitalized companies. The largest group, by assets, was concentrated in institutions which had net worth to assets ratios between 3% and 6%. And a still not insignificant amount of companies and assets was in the low capitalization or insolvent groups. It is estimated that solvent thrifts, which do not currently meet the proposed 6% standard, need to raise $25 to $35 billion in additional capital within the next two and one-quarter years.

Table 5

GAAP-Solvent Thrifts (a)
By Number and Assets
As of September 30, 1988

(Dollars in Millions)

	Number		Assets	
	Amount	%	Amount	%
GAAP-Solvent (b)				
6% or over net worth	1,231	41%	$ 283,399	21%
3% - 6% net worth	963	32	620,998	47
0% - 3% net worth	396	13	280,987	21
Total	2,590	86	$1,185,384	89
GAAP-Insolvent				
Resolved before 12/31/88	77	2	$ 40,633	3
Unresolved at 12/31/88	358	12	102,189	8
Total	435	14	$ 142,822	11
Grand Total	3,025	100%	$1,328,206	100%

(a) Insured by FSLIC.
(b) Net worth greater than $0, as measured by Generally Accepted Accounting Principles.

Source: Federal Home Loan Bank Board Data.

Raising the required $25 to $35 billion of capital for thrifts will be a formidable task, but it is a necessary step which must be taken to ensure the future health of the industry and the insurance fund. However, the two and one-quarter year time frame is, in all probability, unrealistic. Instead, four and one-half to five years is a more realistic horizon, subject, however, to certain conditions discussed later in Section IV of this Paper.

Capital can be generated from three sources:

1. Retention of industry earnings.
2. Sales of capital securities, e.g. common or preferred stock or qualifying subordinated debt.
3. Contributions of capital made by outside investors acquiring S&Ls.

The potential contribution of each of these sources is discussed below.

Increasing Capital through Retained Earnings

The ability of a company to increase the ratio of its capital, or net worth, to assets through its own earning power is governed by mathematical relationships. Quite simply, increasing the amount of net worth relative to assets is determined by:

1. A company's earnings in comparison with its size, called the return on assets ratio (ROA), and often expressed as a percent or in basis points. The higher an association's ROA, the faster and greater the company is able to build its net worth.

2. How fast a company is growing. For a given rate of earnings, slower growth companies will increase net worth ratios faster than higher growth companies.

3. How much of a dividend a company pays out of its earnings. A company which retains most of its earnings by paying a low dividend will build capital faster than a company which pays out a substantial portion of its earnings to stockholders.

The interrelationship of these factors determines how fast a financial institution will be able to increase its capital ratio. Table 6 illustrates these relationships by showing how long it takes companies starting out with a 3% net worth to assets ratio, as measured by Generally Accepted Accounting Principles (GAAP), to reach 6% net worth to assets. The table shows that companies which have high ROAs or earnings rates combined with low growth rates, and which do not pay dividends, can increase their net worth to assets ratio from 3% to 6% within five years, just by retaining their earnings. Conversely, companies with low ROAs and high growth rates have deteriorating capital ratios and cannot even maintain their initial 3% net worth to assets ratio. Tables 7 and 8 illustrate the same point for companies starting out with capital ratios of 4% and 5%, respectively.

Table 6

Length of Time Required to Increase
The Ratio of Net Worth to Assets From 3% to 6%
Based on Various Earnings Rates (Return on Assets)
and Annual Asset Growth Rates (a)

Earnings Rate: Return on Assets (In Basis Points)	Number of Years to Reach 6% Capital Assuming Annual Asset Growth Rate			
	0%	5%	10%	15%
10	10 + years	(b)	(b)	(b)
20	10+	(c)	(b)	(b)
30	10	10+ years	(c)	(b)
40	8	10+	(c)	(b)
50	6	10+	(c)	(c)
60	5	8	10+ years	(c)
70	5	7	10+	(c)
80	4	6	9	(c)
90	4	5	7	10+ years
100	3	4	6	10

(a) Assumes earnings will be transferred to capital (no dividend payout).

(b) Assets grow faster than net worth, and, consequently, net worth to assets ratio declines.

(c) Net worth to assets ratio initially increases, but eventually plateaus before reaching 6%.

Table 7

Length of Time Required to Increase
The Ratio of Net Worth to Assets From 4% to 6%
Based on Various Earnings Rates (Return on Assets)
and Annual Asset Growth Rates (a)

Earnings Rate: Return on Assets (In Basis Points)	Number of Years to Reach 6% Capital Assuming Annual Asset Growth Rate			
	0%	5%	10%	15%
10	10 + years	(b)	(b)	(b)
20	10	(c)	(b)	(b)
30	7	10+ years	(b)	(b)
40	5	10+	(c)	(b)
50	4	8	(c)	(b)
60	4	6	10+ years	(c)
70	3	5	10	(c)
80	3	4	7	(c)
90	3	4	5	10+ years
100	2	3	4	8

(a) Assumes earnings will be transferred to capital (no dividend payout).

(b) Assets grow faster than net worth, and, consequently, net worth to assets ratio declines.

(c) Net worth to assets ratio initially increases, but eventually plateaus before reaching 6%.

Table 8

Length of Time Required to Increase
The Ratio of Net Worth to Assets From 5% to 6%
Based on Various Earnings Rates (Return on Assets)
and Annual Asset Growth Rates (a)

Earnings Rate: Return on Assets (In Basis Points)	Number of Years to Reach 6% Capital Assuming Annual Asset Growth Rate			
	0%	5%	10%	15%
10	10 years	(b)	(b)	(b)
20	5	(b)	(b)	(b)
30	4	10+ years	(b)	(b)
40	3	8	(b)	(b)
50	2	5	(c)	(b)
60	2	4	10+	(b)
70	2	3	6	(c)
80	2	2	4	(c)
90	2	2	3	9 years
100	1	2	3	5

(a) Assumes earnings will be transferred to capital (no dividend payout).

(b) Assets grow faster than net worth, and, consequently, net worth to assets ratio declines.

(c) Net worth to assets ratio initially increases, but eventually plateaus before reaching 6%.

Since it is critical for the industry to reach higher levels of net worth, it is important to understand how much capital can realistically be internally generated through retention of earnings. The first step in this analysis is evaluating the industry's current earning power. Tables 9 and 10 show the distribution of companies and assets by ROA and net worth ratio as of September 30, 1988.

Table 9

Number of GAAP-Solvent Thrifts (a) by GAAP Net Worth to Assets Ratio and Earnings Rate (Return on Assets) As of September 30, 1988

1988 Earnings Rate (b): Return on Assets (In Basis Points)	GAAP Net Worth to Assets Ratio (c)							Total
	0 - 1%	1 - 2%	2 - 3%	3 - 4%	4 - 5%	5 - 6%	6% and over	
less than 0	58	53	67	78	53	52	89	450
0 - 9	8	7	15	15	18	13	18	94
10 - 19	7	11	14	26	22	4	22	106
20 - 29	6	10	13	30	29	21	36	145
30 - 39	4	13	21	28	38	27	52	183
40 - 49	6	7	16	19	42	33	55	178
50 - 59	1	8	10	24	24	41	96	204
60 - 69	2	1	7	16	22	39	100	187
70 - 79	1	0	4	14	33	29	114	195
80 - 89	0	4	5	8	16	26	92	151
90 - 99	2	0	4	7	10	13	105	141
100 and over	0	2	9	16	28	49	452	556
Total	95	116	185	281	335	347	1,231	2,590

(a) Thrifts insured by FSLIC with net worth, as measured by Generally Accepted Accounting Principles, greater than $0.

(b) Based on annualized earnings rates through the third quarter of 1988.

(c) Net worth as measured by Generally Accepted Accounting Principles.

Source: Federal Home Loan Bank Board Data.

Table 10

Assets Held by GAAP-Solvent Thrifts (a)
by GAAP Net Worth to Assets Ratio
and Earnings Rate (Return on Assets)
As of September 30, 1988

(Dollars in Millions)

1988 Earnings Rate (b): Return on Assets (In Basis Points)	GAAP Net Worth to Assets Ratio (c) 0 - 1%	1 - 2%	2 - 3%	3 - 4%	4 - 5%	5 - 6%	6% & over	Total
less than 0	$36,687.9	$26,786.0	$44,521.4	$28,929.6	$29,321.1	$19,941.2	$24,357.9	$210,545.1
0 - 9	22,377.2	9,679.4	16,121.9	40,112.7	8,385.9	11,595.6	8,562.8	116,835.5
10 - 19	32,832.4	2,804.3	9,960.2	12,039.5	9,439.6	292.0	9,604.1	76,972.1
20 - 29	3,040.0	11,924.3	9,530.7	17,915.8	23,394.6	6,288.4	5,083.6	77,177.4
30 - 39	1,253.4	8,397.9	20,100.3	25,817.8	29,487.7	7,276.2	23,479.3	115,812.6
40 - 49	3,127.2	544.5	6,070.7	16,107.3	25,072.7	19,696.9	16,136.3	86,755.6
50 - 59	185.0	3,128.2	4,057.2	7,948.1	42,837.6	53,536.4	17,196.1	128,888.6
60 - 69	101.4	46.6	1,337.5	2,882.7	9,335.0	28,404.6	42,263.0	84,370.8
70 - 79	15.4	0	1,423.9	4,004.4	31,467.1	7,070.2	20,716.6	64,697.6
80 - 89	0	139.7	349.1	5,051.5	34,836.1	6,230.8	20,075.9	66,683.1
90 - 99	99.5	0	2,847.5	3,347.8	3,213.1	19,296.9	20,059.9	48,864.7
100 and over	0	423.5	1,072.4	2,635.2	6,169.6	21,616.5	75,863.4	107,780.6
Total	$99,719.4	$63,874.4	$117,392.8	$166,792.4	$252,960.1	$201,245.7	$283,398.9	$1,185,383.7

(a) Thrifts insured by FSLIC with net worth, as measured by Generally Accepted Accounting Principles, greater than $0.

(b) Based on annualized earnings through the third quarter of 1988.

(c) Net worth as measured by Generally Accepted Accounting Principles.

Source: Federal Home Loan Bank Board Data.

Table 11 combines the information on profitability in Table 10 with the time frames to build capital contained in Tables 6 through 8 to develop a sense of how fast the industry would be able to build net worth on its own in an interest rate environment similar to 1988 and without the explicit and hidden charges contained in the Administration Proposal.

Table 11

Assets Held by Thrifts (a)
by Companies' Ability to Maintain or Achieve a
6% GAAP Net Worth to Assets Ratio Within 5 Years
by Asset Growth Rate (b)
As of September 30, 1988

(Dollars in Millions)

	No Growth		5% Annual Asset Growth		10% Annual Asset Growth	
	Assets	%	Assets	%	Assets	%
1. Well capitalized; **sufficient** earnings to maintain 6% GAAP net worth	$259,042	22%	$235,791	20%	$178,979	15%
2. Well capitalized; **insufficent** earnings to maintain 6% GAAP net worth	24,359	2	47,608	4	104,420	9
3. GAAP net worth below 6%; earnings **sufficient** to grow to 6% within 5 years	344,962	29	217,824	18	53,313	5
4. GAAP net worth below 6%; earnings **insufficient** to grow to 6% within 5 years	557,021	47	684,161	58	848,672	71

(a) Insured by FSLIC.
(b) Based on annualized earnings rates through the third quarter of 1988.

Source: Federal Home Loan Bank Board Data.

Table 11 shows that:

1. Less than 25% of the industry had sufficient earning power in 1988 to maintain a 6% capital ratio with low asset growth. With higher asset growth, the percentage would drop below 20%.

2. Approximately 30% of the industry had GAAP net worth ratios below 6%, but had the earning power to grow capital to the 6% level in five years in a no growth mode. If these companies grow even slowly, however, the proportion would drop from almost 30% to below 20%. Furthermore, should these companies try to grow fast, only a small proportion could significantly enhance their capital base through retained earnings.

3. Approximately 50-60% of the industry had GAAP net worth ratios below 6%, combined with too low an earning power to raise net worth to the 6% level within five years, even with a low growth approach. Using a higher growth strategy, the great majority of companies would be unable to move their net worth ratios up significantly within a five year period.

The significance of the numbers in Table 11 is that, in a low growth environment before the Administration Proposal, the industry could increase capital through retained earnings, but many associations would still not be able to meet target levels within five years, let alone by 1991.

Increasing Capital by Issuing Securities

The second source of capital, issuing securities, has been a very significant source of funds for the industry during the 1980s. Information compiled by Shearson Lehman Hutton, a major investment banker, shows that, between 1980 and 1988, thrifts issued over $15 billion in equity securities and over $4 billion in subordinated debt. However, there have been few issues within the past year. Nevertheless, the capital markets could pr[illegible] fruitful again at some future time, provided the fundamentals of [illegible] industry and individual companies offer the prospect of satisfactory returns to investors. Basically, investors who purchase either stock or subordinated debt look to the present and future earnings of the company. In the case of stock, investors seek a combination of dividends and appreciation in value, both of which depend totally on the ability of the company to generate solid, and preferably increasing, profits. In the case of subordinated debt, investors must feel confident the company can earn enough to pay the interest on these obligations and repay the principal.

Increasing Capital through New Investors

The potential also exists for other investors to seek to acquire thrifts. These investors could include commercial banks, other thrifts with excess capital, and other non-financial institution investors similar to the ones which purchased defunct thrifts from the FSLIC in 1988. However, new investors will only put their money in thrifts if they can obtain a market return on their funds (as measured by earnings divided by the average equity investment and termed return on equity-ROE). Again, simple mathematical relationships can be used to show the kinds of returns various earnings rates will provide an investor. Table 12 indicates that only ROAs at the high end of the industry scale will be able to provide the kind of market return sought by investors putting their capital at risk. Otherwise, they would be better rewarded by putting their funds in an insured certificate of deposit. To put market returns in perspective, for the twelve months ending September 30, 1988, the 400 companies making up the Standard and Poor's 400 Industrial Index averaged a return on equity of 18%.

Table 12

Return on Average Equity (ROE)
For a Well Capitalized Thrift
by Earnings Rate

Earnings Rate (ROA) (In Basis Points)	Return on Equity ROE
100	16%
90	14
80	13
70	11
60	10
50	8
40	7
30	5
20	3
10	2

Impact of Administration Proposal on Thrifts' Ability to Raise Capital

Despite the obvious need for additional capital within the savings and loan industry, the Administration Proposal severely limits, and almost undoubtedly will prevent, many thrifts from increasing their capital from any of the three aforementioned sources. Under the Administration Proposal, thrift earnings will most definitely be lower, because of the increase in deposit premiums and the reduced dividends from the Federal Home Loan Banks. Consequently, both strong and weak companies will be hindered in their attempt to build capital through retained earnings. And, quite frankly, the vast bulk of the industry will not have the earning power to generate $25 to $35 billion in additional net worth over the next two and one-quarter years to meet the expected capital target levels.

The obvious alternative will be to seek capital through the securities markets or direct investment. However, because of the uncertain earnings outlook for the industry, capital formation through outside investment will be discouraged as well. In particular, the specter of a potential 35 basis point deposit premium - or perhaps even higher - would cloud the entire investment environment. **No sensible investor would put funds into an industry where the government has a blank check to confiscate the industry's earnings for reasons beyond a well-managed company's means to control.**

As associations earn less money under the Administration Proposal, many weak companies will have no hope of increasing capital to acceptable levels, and thus will be liquidated. As more thrifts are closed, and savings exit the system, the deposit premium will almost assuredly rise to 35 basis points--or beyond--to pay for all the agency obligations. In a vicious spiral, the higher deposit premium will bring even more companies down, leaving whatever healthy portion of the industry remains to foot the bill for problems it did not create.

Under these circumstances, **it is a pure flight of fancy to assume any new capital can be attracted to the industry.**

And in a related vein, the premium differential between thrifts and banks will provide an incentive for banks not to invest in S&Ls. Banks need only play a waiting game; as more thrifts, forced into insolvency, are subsequently liquidated, banks can capture the deposits and continue to pay the lower premium assessments assigned to them.

In short, the ability to meet the capital guidelines will depend heavily upon the thrift industry's ability to produce steady, predictable and meaningful net income and/or to attract outside capital. Yet that is just what the Proposal, with its higher explicit, hidden, and contingent premiums, prevents.

Worse yet, and the forerunner of the next big financial disaster, will be the costs associated with the failure of a large part of the industry to meet the capital standards.

One Final Word on Capital

Despite the apparently bleak picture painted by Table 11 regarding the capital prospects of a large segment of the solvent savings and loans, it is not inconceivable that these thrifts could be restored to full health through policies designed to foster a solid earning stream and access to additional capital. For example, raising the aforementioned $25 to $35 billion in capital necessary to bring the industry to a 6% target level over a five year period would require a 40 basis point to 60 basis point ROA (assuming no asset growth)[1]. Fifty percent of the solvent industry's assets are already held by companies which earned 40 basis points or more in 1988, and 30% by associations which earned 60 basis points or more in 1988. Many of these firms already have capital that exceeds 6%, and could easily acquire under-capitalized associations. At the same time, strong, well-managed, highly capitalized thrifts could raise additional capital, for further acquisitions of under-capitalized thrifts. Finally, outside investors with excess capital or access to capital could acquire under-capitalized thrifts. Thus, a good part of the potential problems embedded in the GAAP-solvent segment of the industry could be solved by:

1. Giving all companies, regardless of their current capitalization or past history, a fair shot at achieving a reasonable level of profitability, assuming they are competently managed with respect to interest-rate risk, credit risk, and expense control.

   This means no extra "taxes," explicit or implicit.

2. Creating an environment in which the strong companies can go to the capital markets to raise new funds. To do so, associations will have to have good long-term earnings prospects.

   This means no extra "taxes," and certainly no blank check to confiscate industry earnings.

3. Recognizing that a certain amount of industry consolidation is inevitable and will improve total earnings and capital in the long run.

   This means working with, rather than against, strong, healthy companies during the process of disposing of failed or sick companies. Again, this means no extra "taxes," and certainly no blank check to confiscate industry earnings.

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[1] This estimate of the necessary ROA is derived by dividing the capital deficiency ($25-$30 billion) by the total assets held by GAAP-solvent thrifts ($1.2 trillion) divided by the number of years over which the capital must be raised (five).

4. Creating an environment in which outside legitimate investors will want to bring new capital to the industry based on long-term earnings prospects from the basic business (rather than speculation on some sort of quick capital gain).

   Again, this means no extra "taxes," and certainly no blank check to confiscate industry earnings.

The Proposal Guarantees Banks a Competitive Advantage over Thrifts

Even though the Proposal requires thrifts to operate under the same capital, accounting, safety and soundness, and other regulatory standards as banks, the Proposal subjects thrifts to much higher explicit and hidden deposit insurance premiums than banks. Table 13, which follows, sets out the differences between the total premiums that thrifts have paid to date and will pay under the Proposal and those that banks have and will pay. As the last column of the table makes clear, the difference is significant.

Table 13

Comparison of S&L and Bank Insurance Premiums

(In Basis Points)

Year	(1) Actual Premium Paid by S&Ls 1984-1989 and Projected Premiums Per Administration Proposal	(2) Estimated Cost of Taking of Federal Home Bank Capital and Income(b)	(3)=(1)+(2) Total Cost to S&Ls of Administration Proposal(c)	(4) Actual Premium Paid by Banks 1984-1989 and Projected Premiums Per Administration Proposal	(5) Projected Premiums for Banks with Rebate(e)	(6)=(3)-(5) Excess of Cost to S&Ls Over Bank Premiums
1984	8.3	N/A	8.3	8.0(d)	8.0	.3
1985	20.8(a)	N/A	20.8	8.3	8.3	12.5
1986	20.8(a)	N/A	20.8	8.3	8.3	12.5
1987	20.8(a)	N/A	20.6	8.3	8.3	12.5
1988	20.8(a)	N/A	20.8	8.3	8.3	12.5
1989	20.8(a)	4	24.8	12.0	12.0	12.8
1990	20.8(a)	6	26.8	12.0	12.0	14.8
1991	23.0(a)	6	29.0	15.0	15.0	14.0
1992	23.0	7	30.0	15.0	15.0	15.0
1993	23.0	8	31.0	15.0	15.0	16.0
1994	18.0	8	26.0	15.0	15.0	11.0
1995	18.0	9	27.0	15.0	8.0	19.0
1996	18.0	10	29.0	15.0	8.0	21.0
1997	18.0	11	29.0	15.0	8.0	21.0

(a)The increase from [illegible]is points to 20.8 basis points was caused by a special assessment of 1/8 of 1 percent of deposits. This spe[illegible] assessment was scheduled to be phased down under the CEBA legislation, so that total assessments should have been 18.7 basis points in 1987, 16.6 basis points in 1988, 14.6 basis points in 1989, 12.5 basis points in 1990, and 10.4 basis points in 1991.

(b)Includes dividends lost to members due to (1) cost of foregone earnings at 9% cost of capital on approximately $2.0 billion expropriation of FHLB retained earnings; (2) $300 million annual expropriation of FHLB earnings; and (3) foregone earnings on the $300 million annual contribution with 9% cost of capital.

(c)Assumes that FDIC does not exercise discretion to increase the deposit premium to 35 basis points.

(d)Includes effect of rebate.

(e)Assumes rebate of 7 basis points begins in 1995. Based on Written Testimony of J. William Seidman Before House Banking Committee, dated February 28, 1989, and Section 208 of S.413.

N/A: Not applicable.

But, in fact, the difference between thrift and bank deposit premiums is much worse than even disclosed in Table 13 because the FDIC, as noted earlier, is likely to quickly raise the thrift deposit premium to 35 basis points. That premium increase assures that banks will devour thrifts and with them, their promotion of economical home finance. Table 14, which follows, demonstrates the huge difference between what banks will pay for deposit insurance (and only on domestic deposits at that) and what thrifts will pay if their deposit premium is 35 basis points.

Table 14

Comparison of S&L and Bank Premiums if Thrift Premiums Increase to 35 Basis Points

(In Basis Points)

Year	(1) Total Cost to S&Ls of Administration Proposal Without Increase in Premiums to 35 Basis Points	(2) Increase in S&L Premium if Raised to 35 Basis Points	(3)=(1)+(2) Total Cost to S&Ls if Premium Raised to 35 Basis Points	(4) Premium for Banks With Rebate(c)	(5)=(3)-(4) Excess of Cost to S&Ls Over Bank Premiums
1990	26.8	N/A	N/A	N/A	N/A
1991	29.0	8.2	37.2	15.0	12.2
1992	30.0	12.0	42.0	15.0	27.0
1993	31.0	12.0	43.0	15.0	28.0
1994	26.0	17.0	43.0	15.0	28.0
1995	27.0	17.0	44.0	8.0	36.0
1996	29.0	17.0	46.0	8.0	38.0
1997	29.0	17.0	46.0	8.0	38.0

(a)See Table 13, column 3.

(b)Represents difference between increased premium and scheduled premium. Assumes that in 1991, premium would increase by 50 percent of 1990 premium (20.8 basis points) and in 1992, would increase again to 35 basis points.

(c)Assumes 7 basis point rebate begins in 1995.

N/A: Not applicable

Source: FDIC data; FHLBB data; Adminsitration Proposal.

As discussed earlier in this section, the absolute costs associated with the Proposal's standard thrift deposit premium, the FHLBank taking, and the virtually assured increase of the thrift deposit premium to at least 35 basis points will significantly impact the thrift industry. When that impact is coupled with the competitive advantage given to the commercial bank competition, the burden on thrifts is overwhelming.

It is not possible to make the argument on a logical or on an economic basis that banks should have a competitive advantage. Nor is there a public policy rationale based on safety and soundness. Indeed, the Federal Reserve and Comptroller of the Currency capital guidelines make clear the relative absence of risk in home mortgage lending. Especially if the thrift charter is narrowed to focus even more on residential lending (as proposed herein), thrift operations will be substantially safer and sounder than a commercial bank's. There is no justification for the huge tax on S&Ls. Giving commercial banks an unfair competitive advantage is either accidental (and therefore poor public policy) or intended to further cripple the thrift industry.

II. THE UNITED STATES GOVERNMENT MUST FACE UP TO ITS RESPONSIBILITY AND BEAR THE COST

The United States Government, which pledged its full faith and credit to depositors in insured institutions, must face up to its obligation. Who passed the laws to deregulate the business? Who hired the regulators who should have enforced the laws? Who was given the job of oversight? It wasn't the individual savings and loan institutions or the FHLBanks which they own.

Causes of the FSLIC Failure

When the topic of "blame" surfaces, so too does the refrain "there is enough blame to go around." While that may be true, it's important to pinpoint accountability, since equity and justice cry out for some linkage between culpability and fiscal responsibility. Fortunately, it is as easy to identify the villains here as it is the innocent.

> **The federal government's bungled, unplanned deregulation and the lowering of standards.** The deregulatory process, to the extent that it had any philosophical foundation, could not have been executed with less planning, professionalism or competence. Despite the interest rate risk associated with borrowing short and lending long, the Federal Government first deregulated only liabilities, thereby making them more interest rate sensitive. Later, and only after much damage had already been done to the thrift industry, regulators introduced interest rate sensitivity to the asset side of the balance sheet with the authorization of adjustable rate mortgages. In the 1980s, capital standards were lowered and limits were lifted on brokered deposits. Loan to value relationships, and lending and investment authority were also liberalized. And most recently, in 1987, the Federal Government passed the Competitive Equality Banking Act (CEBA), which included provisions requiring, in effect, that thrift regulators forebear from enforcing their already lenient capital and appraisal regulations.
>
> **Federal Home Loan Bank Board (FHLBB).** The FHLBB was ill-prepared to supervise a deregulated savings and loan industry. Consistently throughout the turbulent 1980s, both political appointees and FHLBB staff regulated thrift gamblers as though they were the neighborhood bridge club. At the same time, managers of prudent, well-capitalized companies complained about high risk practices to FHLBB supervisors with little impact.
>
> **Office of Management and Budget (OMB).** When the FHLBB finally realized that its staff was inadequate both in numbers and competence, additional personnel and flexibility in hiring were requested from OMB. Astonishingly, OMB repeatedly denied the request, despite the fact that these costs are paid, not by the government, but by the savings and loan industry, and despite the fact that the savings and loan industry supported the request.

State legislatures and regulators. Some state legislatures and regulators, wishing to keep their institutions from straying from the fold and becoming federally chartered, tossed aside sound judgement, and in some cases, their scruples. Many states authorized wide thrift powers, and then dispensed thrift charters as if they were selling lottery tickets (backed by the FSLIC, of course).

Criminals, highrollers, and other undesirables. Perhaps the worst aspect of the deregulatory process, was the smell it created when combined with regulatory incompetence. The scent of easy money and easy "marks" was so strong that bad people poured into the thrift industry. With unlimited access to insured deposits and with low capital requirements, crooks could use insured funds to invest in any extravagant project, loan, or perquisite they, quite literally, could imagine. Deregulation attracted sharks to the thrift fish tank. The entrails left from the subsequent feeding frenzy now rot before the American public.

Trade associations. The thrift industry trade associations during the early and mid-1980s helped foster complacency about go-go activities. Trade associations, by their nature, find it difficult to accept changes which will lead to the elimination of any of their members. Protestations of prudent thrift managers were again ignored as trade groups sought to preserve membership fees. Instead, the trade associations followed the urgings of the highrollers and crooks, many from Texas and California, and slowed down the FHLBB's much belated attempts to address the problem.

Depression in the Southwest. Obviously, the economic depression in the Southwest was an important factor in increasing the size of the thrift losses, but as the Government Accounting Office (GAO) has pointed out, the confluence of a bungled deregulatory process, together with inept regulation and supervision, assured that the thrift industry would be unprepared for the inevitable regional downturn. Thrifts and banks must be operated and regulated so that they can weather the entire business cycle, not just the good years.

Healthy Thrifts Should Not Be Punished

Although there "may be plenty of blame to go around," the one place blame does not reside is with the more than 2000 prudently managed, healthy, honest institutions which did not cause any of the losses. In fact, many of these same companies warned about rampant, unsafe and unsound practices. (Not only did World Savings management badger regulators and supervisors on an ongoing basis, but the Association's parent, Golden West Financial Corporation, went on record as early as 1980 and in several other Annual Reports. See Appendix 3).

Healthy, well-managed institutions are clearly blameless in this scandal, yet, sadly, they have been its principal victims. Through the end of 1988, the industry paid $4.5 billion in special additional FSLIC assessments, of which the largest portion was paid by the healthy segment. Further, earnings and capital of healthy institutions have been severely impacted by insolvent and inadequately capitalized companies' uncontrolled competition for deposits and loans. And yet, the Proposal calls for healthy savings and loans to share the cost of cleaning up the mess. Well-managed, well-capitalized institutions bear no responsibility for the losses and any attempt to have them pay for these losses is simply punitive, not affordable and counterproductive: Counterproductive because healthy companies will be weakened, the acquisition of additional capital retarded and insolvencies increased, causing additional losses which will have to be funded.

Recent headlines dealing with Third World debt bring to mind an anomaly concerning the government's views of banks and of thrifts. For much of the last decade, bank regulators have been very lax or charitable, if you will, in requiring writedowns of Third World loans by U.S. banks. Many of the country's largest banks would have had their capital depleted, if they had been required to write these loans to market. Treasury policy, furthered by the World Bank and the International Monetary Fund, has been tailored to avoid a "hit" to banks. And now, there are new suggestions of a Treasury plan which may provide various guarantees and benefits to banks in connection with their Third World debt.

All of the above is not to suggest that these government policies supporting the money center banks (and other banks, as well) are wrong. But it does point to an anomaly...and the anomaly is as follows:

> The banks that have been saved literally by government policy have been the very banks that made the terrible loans, the "guilty" parties, whereas in the FSLIC crisis, the government has demanded that the innocent, well managed, prudently operated thrifts who did not make bad loans or create losses, pay for losses caused by a bungled deregulatory policy, incompetent regulators and crooks and highrollers (most of whom got away scot-free).

Role of the Government

Everywhere there are loud protests about the taxpayers "bailing out" the thrift industry. But it is not thrifts that are being bailed out, but rather their insured depositors who have been assured that the full faith and credit of the government stands behind their savings. Furthermore, there is only one source that has the obligation and resources: the U.S. Government. As Federal Reserve Chairman Alan Greenspan testified to this Committee on February 23, 1989:

> When so much money is needed to make up for such large losses, partly from mismanagement, and in no small part due to fraud, is it reasonable to ask the taxpayers to pay any part of these costs?
>
> It is. The basis for my answer goes far beyond the Congressional pledge of the full-faith and credit of the United States behind insured deposits. The reason for public expenditure to support deposit insurance is the basic benefits to the economy as a whole that we derive from deposit insurance. The certainty and stability provided by deposit insurance benefits the nation as a whole, while it protects the individual from catastrophic loss. By giving the public confidence in the safety of its funds we avoid the deposit withdrawal and losses that disrupted the payments system and the savings and investment process in the 1930s. Losses of the kind that we face today should not happen, but with the gains to society as a whole that come with deposit insurance we must accept both the possibility and the reality that there will be losses to be borne by society as a whole.

Implementing public policy is classically a government responsibility. And with the FSLIC debacle, the government role is even more appropriate given its 55-year commitment to deposit insurance, its very large role in causing the losses, and the simple financial fact that a special tax on thrifts merely weakens the industry at the very time that institutions must build capital. As indicated elsewhere, the special tax on thrifts may very well create losses in excess of the funds raised from the thrifts. Bad public policy is one thing. Insane public policy is another.

Government pays the cost of implementing public policy by appropriating public money, not by taxing a weakened industry out of existence (unless, of course, eliminating the industry and thus negatively impacting economical home finance, is the real public policy objective). The FSLIC insolvency is, however unpleasant a truth it may be, a taxpayer problem because deposit insurance is a government contract.

III. THE ADMINISTRATION PROPOSAL FOR RAISING AND DISBURSING FUNDS AS WELL AS ALLOCATING RESPONSIBILITY TO PAY FOR FSLIC'S INSOLVENCY SHOULD BE SIMPLIFIED

The Cost of the FSLIC Insolvency is in Excess of $100 Billion

It is beyond the scope of this testimony to estimate the exact dollar amount that FSLIC needs to meet its responsibilities. Whatever the exact number turns out to be, it is huge and in the $100 billion plus range.

The Mechanics for Raising Funds and Disbursing Them to Pay for FSLIC's Insolvency Are Too Complex

Budget games cause the Proposal's complexity. The drafters of the Administration Proposal apparently have to function in an environment in which there will be no new taxes and in which problems which cost money are frequently hidden off-budget, and activities which create income, at least during the period they create such income, are put on-budget. Carol Cox, director of Citizens for a Responsible Federal Budget, has suggested that the Administration's Proposal in dealing with a $100 billion loss is so "clever" that it actually produces income on the budget while the losses are paid.

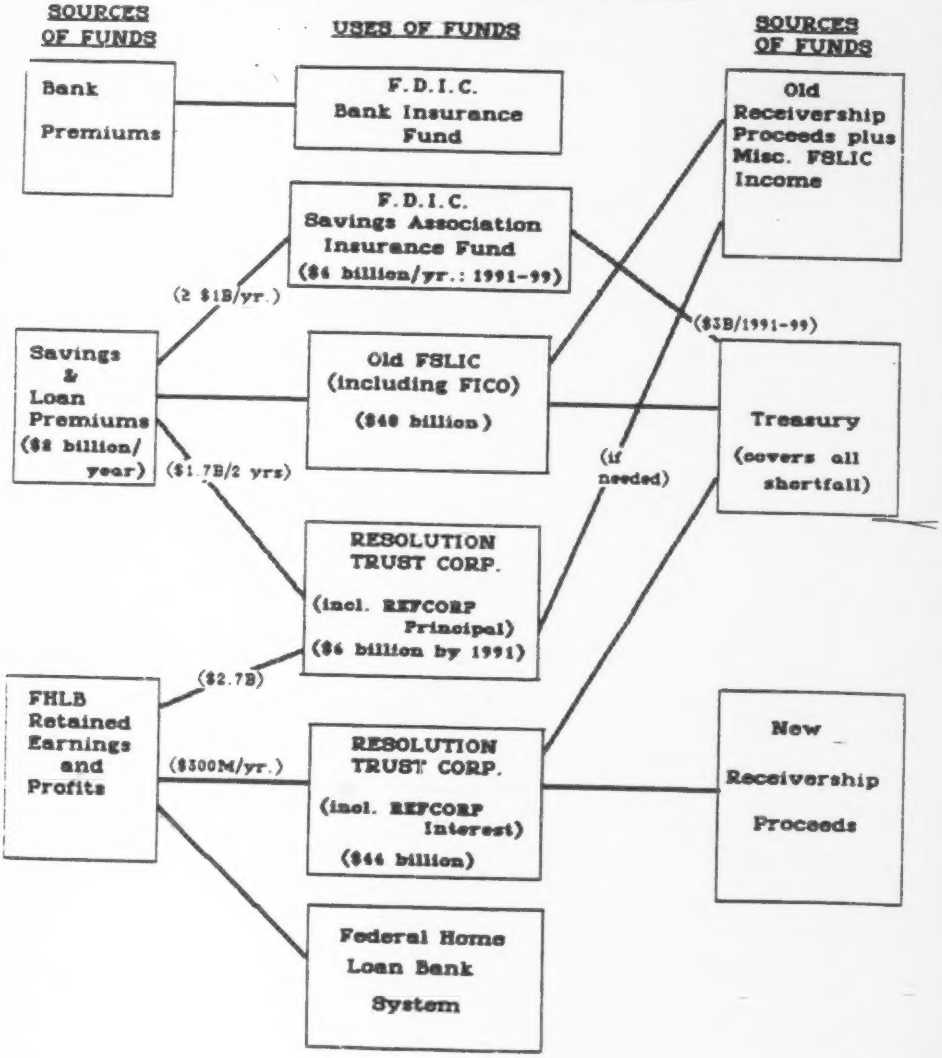
According to the Wall Street Journal of February 22, 1989:

> I'm amazed, amused, and bemused, says Carol Cox, director of the bipartisan Citizens for a Responsible Federal Budget. Would you believe the thrift crisis is going to save us money and reduce the deficit? Well, that's just what the budget says! The deposit-insurance artifice, involving off-budget financing, is the biggest in a bag full of tricks that Budget Director Richard Darman used this year to pull off a remarkable budgetary coup...
>
> ...The money borrowed by the new corporation [the Resolution Funding Corporation], however, will simply be handed over to the government, and will appear on the federal books as a "receipt." Thus, rather than increasing the budget deficit, the scheme actually reduces it.

This off-budget financing of the FSLIC solution makes the Proposal very complicated. A diagram of the Administration's Proposal submitted as a part of Chairman Seidman's testimony to the Senate Banking Committee on February 28 illustrates the Proposal's complexity.

As indicated in the following diagram, the Proposal involves several government corporations in its disbursal mechanism and asks several other entities to contribute the funds to be disbursed. The role of each of these corporations and entities is described below.

ADMINISTRATION'S FINANCING PROPOSAL


SOURCES OF FUNDS
USES OF FUNDS
SOURCES OF FUNDS
Bank Premiums
F.D.I.C. Bank Insurance Fund
Old Receivership Proceeds plus Misc. FSLIC Income
F.D.I.C. Savings Association Insurance Fund ($4 billion/yr.: 1991-99)
(≥ $1B/yr.)
($3B/1991-99)
Savings & Loan Premiums ($2 billion/ year)
Old FSLIC (including FICO) ($40 billion)
Treasury (covers all shortfall)
($1.7B/2 yrs)
(if needed)
RESOLUTION TRUST CORP. (incl. REFCORP Principal) ($6 billion by 1991)
($2.7B)
FHLB Retained Earnings and Profits
($300M/yr.)
RESOLUTION TRUST CORP. (incl. REFCORP Interest) ($44 billion)
New Receivership Proceeds
Federal Home Loan Bank System

Corporations to Raise and to Disburse Funds for the FSLIC Insolvency:

- Resolution Funding Corporation ("RFC") (identified as REFCORP on the diagram): RFC borrows money in the capital markets, which in turn RFC gives to the Resolution Trust Corporation ("RTC").

- Resolution Trust Corporation: RTC uses funds obtained from RFC to resolve current GAAP-insolvent thrifts as well as all thrifts that fail in the next three years.

- Financing Corporation ("FICO"): FICO borrows funds in the capital markets.

- FSLIC Resolution Fund: The FSLIC Resolution Fund will meet all outstanding FSLIC contractual commitments using money from several sources, including FICO bond proceeds.

- Savings Association Insurance Fund ("SAIF"): SAIF will be responsible for all thrift failures occurring after 1991.

Corporations and Entities Paying for the FSLIC Insolvency:

- Healthy Savings and Loan Associations: Thrifts pay increased deposit insurance premiums for FICO bond interest, for RFC bond defeasance, for FSLIC Resolution Fund Costs, and for SAIF.

- Federal Home Loan Banks ("FHLBanks"): FHLBanks pay their retained earnings to defease FICO bonds and RFC bonds. FHLBanks additionally pay $300 million annually in earnings for RFC bond interest.

- U.S. Treasury: Treasury helps pay interest on RFC bonds, FSLIC Resolution Fund costs and makes contributions to SAIF. The Treasury payments will have to be appropriated annually which means the FSLIC mess will be debated in Congress every year.

Not only are there many entities, RTC, RFC, FICO, SAIF, the FHLBanks, the Treasury, and the thrifts, involved in rescuing the FSLIC, but the disbursement of these entities' income and assets, as a result of the off-budget financing, is complicated and imprecise, as the diagram on the previous page illustrates.

Off-budget financing of FSLIC's insolvency and its resulting complex, contrived structure are bad public policy because off-budget financing is more costly than on-budget financing, creates more uncertainty for people who do business with thrifts because of its ambiguous assignment of financial responsibility, and increases the risk that the unanticipated stresses of the future will reveal a critical design flaw in the complicated funding mechanism.

Two government agencies charged with understanding and monitoring the U.S. budget, the Government Accounting Office ("GAO") and the Congressional Budget Office ("CBO") have recommended that on-budget funds be used to address FSLIC's insolvency. Charles Bowsher of the GAO so testified to the Senate Banking Committee on February 2, 1989, and representatives of the CBO urged that approach both before the Senate Appropriations Committee on March 9, 1989, and before the Senate Banking Committee on March 3, 1989.

Responsibility for Fixing FSLIC Should be Reallocated and Clearly Delineated

The Proposal's assignment to thrifts of financial responsibility for the FSLIC mess goes too far and overreaches the healthy savings institutions' ability to pay and to build capital to the required level. The Proposal also directs too much of the savings and loan industry's deposit insurance premiums to curing old FSLIC problems. It absolutely is not possible for the healthy component of the thrift industry to pay for the mistakes of the past, pay to recapitalize the savings institution insurance fund, and at the same time, rebuild capital.

The parties in interest here, FSLIC, the U.S. Government, and thrifts, should and must be assigned the responsibility to meet this demand for money, but assignments must be made realistically so that additional losses and considerable disruption do not inevitably follow.

The demand for money comes from three sources, or "holes":

1. **FSLIC**: FSLIC needs capital (a) to meet the Government's obligation to pay off depositors of insolvent S&Ls, and (b) to honor FSLIC's outstanding contractual commitments.

2. **A New Savings Institution Deposit Insurance Fund**: The Government and the savings and loan industry need a savings institution insurance fund with sufficient capital to meet the Government's deposit insurance obligations in the future (presently, the Proposal suggests that a fund with assets determined to be equal to 1.20% of savings deposits has sufficient resources).

3. **Many GAAP-Solvent Thrifts Need More Capital**: GAAP-solvent thrifts need this capital to (a) provide the first line of defense against losses before the insurance fund is called on, and (b) to regain the trust of depositors.

The Proposal should be simplified as follows:

- The Government, on-budget, through the Treasury, should pay the costs arising from FSLIC's insolvency, including the cost of resolving GAAP-insolvent thrifts.
- The healthy portion of the thrift industry that will survive should pay to capitalize a new savings deposit insurance fund with its premiums. The premium should be 15 basis points on deposits. (Assuming five percent deposit growth, a 15 basis point deposit premium could yield in 1996 a savings institution deposit insurance fund that is 1.2% of all insured deposits).
- The healthy portion of the savings industry should rebuild its capital through earnings and new equity, and until a thrift meets the new capital requirements, it should not grow, period.

Simplifying the Proposal as described above has several advantages:

- The simplified solution is more realistic because it stands a chance of being accomplished.
- The simplified solution is equitable because it does not ask healthy thrifts to pay any more than the $4.5 billion in special deposit insurance assessments and the $500 million in FHLBank retained earnings that have already been contributed to cleaning up the FSLIC mess these healthy thrifts did not create.
- The simplified solution places the responsibility of rebuilding the thrift industry squarely on the shoulders of the thrift industry itself, where it belongs. Just as the Administration has asked the banks to do. If the Administration wants to cause more pain to the thrift industry, tougher capital requirements, and a return to the thrifts' traditional charter will be quite painful to many.
- The simplified solution provides a faster and less expensive financing mechanism since the monies necessary to meet the Government's deposit insurance obligations are raised on-budget.
- The simplified solution reduces the risks of unidentified design flaws in a complex structure leading to unintended and catastrophic results.
- The simplified solution grants the U.S. Government, consumers, and healthy thrifts (paying a fair and reasonable deposit premium) a fresh start with the FDIC deposit insurance fund

IV. NEEDED STRUCTURAL AND REGULATORY CHANGES

Introduction

The point of view expressed in this section is based upon the philosophy that access to insured deposits is a privilege infused with fiduciary responsibilities and that this access is predicated upon performing an intermediary role for savers and borrowers, rather than engaging in speculative activity. Also underlying the recommendations for structural and regulatory changes is the operating experience and results of World Savings and Loan Association and many, many other well-managed, well-capitalized, conservative thrifts which use consumer savings and make home mortgages.

World Savings is a 76-year old, federally chartered savings and loan association, headquartered in Oakland, California. The Association is financially strong, with over $16 billion in assets and $1 billion in GAAP capital (over 6 percent of assets). Over the last 20 years World has had an annual average compound rate of growth in earnings of 20%, a record equalled by few, if any, commercial banks. As a result of the Company's accomplishments and balance sheet strength, Moody's and Standard and Poor's have awarded World one of the highest credit ratings held by any thrift.

Over the years, World achieved its record of earnings and its strong financial position the old fashioned way--the Association takes in consumer deposits and makes residential loans. In fact, in 1988, World originated almost 29,000 loans amounting to $4.7 billion (a record year); only 10 loans for $8 million were non-residential. Further, as of December 31, 1988, of its total conventional loan portfolio of $12.4 billion, over $12 billion were on residential properties. Moreover, World has grown without sacrificing asset quality. The Company's ratio of non-performing assets (delinquent or foreclosed loans) to total assets, of just 0.41% at December 31, 1988, has consistently been far better than the ratios of leading regional banks.

Suggested Changes in Structure of Chartering and Insuring Agencies

1. There would be two deposit insurance funds, one for insuring commercial banks and one for insuring savings and loan associations. Both would be administered by the FDIC. The insurance logo for banks and S&Ls would be identical. The hysteria over the latter suggestion must be ignored, since objections by banks are based on their desire to have yet another competitive advantage over thrifts. Logic dictates that since both insurance corporations will have the same management and have the full faith and credit behind them, and since capital requirements will be identical, there is no reasonable justification for a separation of logos. Furthermore, with the

changes in structure and regulation proposed herein, it could very well be that depositors in thrifts will even be more secure than customers of banks. The decision should not be based on which industry has more political muscle, but rather on what is the best long-term public policy.

2. There will be no difference in deposit insurance premiums for banks and thrifts by 1991. Bank premiums would be set as described in the Proposal. Thrift premiums would be 15 basis points from the date the legislation becomes effective. Both banks and thrifts will be eligible for premium rebates when the ratio of deposit insurance fund assets to deposits reaches 1.25%.

3. FSLIC's assets and liabilities will be transferred to the Resolution Trust Corp. ("RTC") as the Administration proposes. All GAAP-insolvent thrifts as of the date the legislation is passed and all thrifts which become GAAP-insolvent in the three subsequent years would be seized by the FDIC for resolution. The cost of resolving the foregoing would not be paid by the Savings Association Insurance Fund.

4. There will be no state charters available for federally insured thrifts.

5. The primary purpose of thrifts will be to provide long-term residential financing.

6. Capital requirements will be the same for thrifts and banks, following the principles of the new risk based Federal Reserve and OCC Guidelines (see Federal Register Vol. 54, No. 17, January 22, 1989). Basically, these guidelines require financial institutions to hold high quality capital in amounts proportionate to the risks inherent in their assets, including their off-balance sheet assets, establishing a cushion against possible losses arising from such assets.

7. It is absolutely essential that the credit functions of the Federal Home Loan Bank System (see Appendix 2) be independent of the Treasury. The long standing history of institutional bias of the Treasury against the housing credit allocation function performed by the FHLBanks is well known. Whatever the current appointed Treasury officials may say or do, such institutional bias will be there when the current appointees are gone. Putting the FHLBank credit function under the Treasury is tantamount to a decision to eliminate that socially desirable function.

   Another related issue is the composition of the boards of directors of the individual FHLBanks. Under the current system, the member institutions which are required to purchase and hold a significant amount of stock elect a majority of the directors of the FHLBank to which they belong. The balance of the board are public interest directors appointed by the Chairman of the FHLBB.

   The Administration proposes that the boards of directors be changed to nine members, three from the industry, three appointed by the Chairman of the FHLBB and three elected by the first six, similar to the system utilized by the Federal Reserve Banks.

   Superficially, this change to the Federal Reserve Bank system may be appealing, until it is understood that the requirements of commercial banks to purchase and hold stock in the Federal Reserve Bank is extremely small, especially when compared with the requirements of stock ownership of thrifts in their FHLBanks. The FHLBanks are very different from the Federal Reserve Banks. See Appendix 4.

   To change the composition of the FHLBanks' boards of directors would not only be unfair, but would undoubtedly lead to a weakening of the effectiveness of the credit allocation functions of the FHLBanks.

   At issue also is whether the Federal Home Loan Bank Board, with its supervisory and regulatory responsibilities, will remain independent or report to the Treasury. There are significant advantages and disadvantages to both approaches.

8. The FHLBB will be the chartering agency for all federal savings and loan associations.

Federal Thrift Charter

1. Federally chartered, federally insured thrifts would have only the following powers:

   a. 80% of assets would be in cash, liquidity investments, and mortgages on 1-4 unit family residences and on apartments. These assets could include mortgage-backed securities, as well as residential construction, home equity, and home improvement loans. (Hereinafter all these assets are called "home financing assets").

   b. 20% of assets could be in consumer loans, education loans, commercial real estate loans, land loans (including acquisition, development, and construction loans), and non-residential construction loans. Also included in this 20% would be FHLBank stock, Federal Home Loan Mortgage Corporation (FHLMC) stock owned as of the date of the legislation, fixed assets, real estate owned, goodwill, and service corporation investments. Except for consumer and education loans, no category of assets described herein may exceed 10% of assets.

   c. Thrifts could invest (either in the form of equity securities or loans) 3% of their assets in wholly owned service corporations from their 20% authority as set forth above. Service corporations could only make those investments that their parent could make.

d. Thrifts could not own junk bonds or make direct investments.

(An alternative approach to the 80% requirement in 1.a. above would be to retain the current "qualified thrift lender" test at 60% or raise it only to 70%, but require that there be much closer supervision of the non-housing assets with imposition and strict enforcement of risk-based capital standards reflecting the higher risks, including full capital support for "risky investments.")

2. Federally chartered thrifts will be eligible for membership in the FHLBanks.

3. Commercial banks also will be eligible for membership in the FHLBanks if 65% of their assets meet the requirements of number 1.a. above. Their FHLB advances could not exceed 10% of their assets unless they satisfied the full 80% requirement. Such banks would have to purchase and own stock in FHLBs similar to the requirements for thrifts.

4. If by June 1, 1993, a savings and loan's asset portfolio did not meet the standards described in 1. above, the association would have to become a bank. Institutions would be permitted to move back and forth from/to thrift or bank, if they met the applicable asset composition test.

   Thus, a financial institution will be able to move from being a savings and loan to a bank or the converse at its discretion by adjusting the composition of its assets. Banks will have broader lending authority than savings and loans which will be focussed on residential lending. The advantages of being a savings and loan will be the Internal Revenue Service bad debt deduction, now very modest in scope, and unlimited access to the credit window of the FHLBs. The advantage of being a commercial bank would arise from the flexibility of wider lending authority.

   Since it is anticipated that the capital requirements will be the same for both sets of institutions, there is no reason to require an institution to remain in one category on a permanent basis.

Thrift Capital Requirements

Introduction

The issue of capital is a very emotional one. Companies with qualifying levels of capital believe that companies with "low" capital jeopardize the insurance fund and distort the marketplace, putting the stronger companies at an unfair and costly disadvantage. Companies which have been prudently managed, but have been unable (or not interested) in increasing capital, believe they should have a reasonable chance to meet any new standards.

The public policy issue is how to appropriately balance the safety of the insurance fund and the public, and fairness to well-capitalized institutions, on the one hand and fairness to "under-capitalized companies" on the other. In view of the fact that the lack of strong capital requirements was a key cause of the current disaster, there must be a strong bias in favor of higher capital standards.

Powerful inducements must be established to incent institutions to rapidly meet the capital requirements.

If thrifts are given an extended period to meet the new capital requirements, but are required to pay the Proposal's extraordinary premiums, direct, hidden and contingent, the legislation will have undermined the strong to save the weak.

This would be the worst of all possible worlds. Strong well-capitalized institutions would be competing, as now, with under-capitalized institutions. Based on both common sense and hard empirical data, these under-capitalized institutions would continue to distort both the loan and savings markets.

In addition to the unfair competition from under-capitalized companies, the high likelihood that FDIC would exercise its discretion to further increase the insurance premiums to 35 basis points or higher, would become inevitable since many of these under-capitalized companies would be likely to take inappropriate risk, whatever the quality of supervision and cause further losses to the insurance fund.

There is a stench of capital forbearance in the air and Congress and the Administration must not succumb to its blandishments. Do not doom the thrift industry to being a ward of the government.

Surely, the largest financial scandal in U.S. history, caused in large part by inadequate capital standards and regulatory forbearance should have taught us all a lesson.

Enough is enough.

Following is a discussion of a proposal for reasonable thrift capital requirements which attempts to balance concerns about the safety of the insurance fund and the public, and the viability and health of the fully capitalized firms on the one hand, with the needs of those under-capitalized institutions which demonstrate a sincere desire and ability to achieve the capital requirements, without inappropriate risk taking, but need more time than two years, on the other hand.

1. Thrifts not meeting the capital requirements may not grow.

2. Thrifts would have until June 1, 1993, to meet the new, Federal Reserve risk-based capital requirements, subject to having increased their capital level by at least sixty percent from their capital level at January 1, 1989, to their new Federal Reserve capital requirement by June 1, 1991. Those that have not done so could have their directors and management removed and replaced by the regulators or the thrift could be sold or liquidated.

3. Thrifts that do not meet the risk-based capital requirement by June 1, 1993, could be sold or liquidated by the FDIC.

4. Thrifts may include in the calculation of their Federal Reserve risk-based capital requirement any goodwill acquired prior to the enactment of the legislation, but only to the extent of 50% of their Federal Reserve capital requirement for five years from the date of the legislation and up to 20% for the next five years. The goodwill included in calculating capital requirements would have to be reduced to zero over a 10 year period on a straight line basis, for purposes of calculating capital for regulatory purposes only, and not for profit and loss accounting purposes. (The purpose of the phasedown on the use of goodwill is to determine capital strength only and not to reduce reported earnings).

Additional Miscellaneous Thrift Law Changes that Should be Effected

1. Companies not meeting their capital requirements should not grow, should not pay dividends to stockholders and should not make loans other than on 1-4 unit residences. In addition, their operating plans, particularly with respect to pricing of deposits and loans should be closely monitored.

2. Residential loan to value limits should not exceed 90%, except with private or government mortgage insurance and then the limit should be 95%. Commercial mortgage loan to value requirements should not exceed 80%.

3. Loans to single borrowers should be limited to 25% of net worth.

4. Transactions with non-service corporation affiliates not conducting thrift-related business should be strictly limited. Tie-in arrangements should be prohibited.

5. Loans to insiders or their affiliated companies should be prohibited.

6. The FHLBB should be granted clear authority over the auditing and appraisal process as it relates to thrifts.

7. Criteria for establishing new institutions.

   There are several changes which should be made with respect to criteria for establishing new institutions.

   a. Instead of permitting a savings and loan institution to be controlled by only one person or group, which has been an important factor in the creation of numerous losses, the criteria should be revised to go back to the old requirements setting forth a larger minimum number of owners from the community to be served. One hundred might be an appropriate number.

   b. Minimum dollar amounts of required paid-in capital should be significantly increased for new savings and loans, perhaps to the level of $25 million rather than only $2-3 million.

   c. In general, the chartering authorities should have greater authority to deny applications for new charters or for insurance of accounts, as well as applications for changes in control of a thrift.

8. Except for grandfathered companies, Glass-Steagall barriers should be applied to acquirors of thrifts, until Congress has the opportunity to decide about the appropriateness of barriers between finance and commerce. However, banks should be able to acquire thrifts and thrifts should be able to acquire banks. Acquirors of thrifts should meet applicable capital requirements immediately after any acquisition of either a failed or healthy financial institution.

   Since the 1930s, there has been a tradition in this country separating financial depository services from commerce. Thoughtful people of repute and distinction support each side of the issue. Whichever policy is valid and in the public interest, however, should be decided by Congress and not by regulators under stress seeking to sell insolvent companies.

   Until the last few years, relatively few companies which owned thrifts were involved in commerce. None own banks or may do so. However, the FSLIC sold failed thrifts to a number of groups involved in commerce during the last year and a half. What were the motivations of the acquirors? What are their plans? Does it matter?

   Here are some issues to consider.

   a) A legitimate industrial firm, such as Ford Motor Company, acquires a thrift and intends to operate it as a thrift, building value over the years. It's hard to see a problem here.

b) Now, the industrial company changes its plans and wishes to access insured deposits of the thrift for other purposes -- e.g., support its primary commercial activities, giving it a possible edge over its competitors, or perhaps using insured deposits for some speculative activity such as leveraged buyouts or drilling for oil.

Clearly, this presents a more complicated question, with a series of public policy issues to resolve.

c) Instead of a quality company like Ford, now assume that the acquiror of the thrift is a corporation which is relatively weak financially and the only attraction of the thrift is its access to insured deposits. Or assume the acquiror is a developer seeking to fund its real estate activities.

Where are the lines to be drawn? How will the insurance fund and the public be protected?

Whatever the answer to these questions, the one clear answer is that Congress should face up to the issues and provide guidance, rather than leaving such significant macro issues to be decided by regulators operating under great stress and focussing on micro concerns.

V. NEED FOR A SEPARATE THRIFT INDUSTRY

The thrift industry performs a critical role in providing economical home finance for Americans. Despite all the talk about savings and loans abdicating their role in residential finance, savings and loans originated nearly 50% of all home mortgages in 1988. THAT IS THE SAME PERCENTAGE THEY ORIGINATED IN 1980 BEFORE DEREGULATION. Furthermore over 42% of all outstanding home mortgages reside in the loan portfolios of thrifts.

In understanding the importance of the thrift industry to housing, Jonathan Gray, an industry analyst at Sanford C. Bernstein and Co., Inc., said it best when in a research memorandum he addressed the question:

> Is the Thrift Industry Obsolete?
>
> This question must be clarified. The question may be interpreted as asking either or both of the following:
>
> a) Should thrifts continue to perform their core functions of accepting insured consumer deposits, and financing residential dwellings, but perform these functions as part of the banking system?
>
> b) Should homeownership be financed in some other way?
>
> There is no logically necessary reason for maintaining a separate subsidiary to provide housing finance. However, there is no compelling reason for eliminating such an industry either. As long as the industry is properly supervised, it will function in a manner that does not require taxpayer bailouts.
>
> As to the hypothesis that homeownership be financed in some other way, it must first be understood that thrifts not only perform a mortgage warehousing function, but a savings/investment function as well.
>
> The only other way to finance the residential mortgage market would require complete federalization, the opposite of deregulation. The entire mortgage market would be converted to MBS by the government agencies and financed directly by consumers who would purchase long-term, fixed-income mutual funds (i.e. GNMA funds and the like). The taxpayer would still be exposed to the underwriting risk, as he is now through the agencies' implicit or explicit links to the Treasury.
>
> The problem with financing the entire mortgage market in this fashion is that it transfers a significant amount of principal risk to the saver/investor, and there is a lot of

evidence to support the notion that the consumer is substantially risk averse. He wants a safe haven for his life savings. For example, after growing from $64 to $284 billion in the two years prior to the bond market sell-off of April 1987, long term bond and Ginnie Mae funds fell by $32 billion in the next six months as consumer savers fled before the specter of some $20 billion of principal losses. And when the market crashed in October 1987, the savings poured into banks and thrifts.

Furthermore, it is important that would-be architects of our financial system be cognizant of the size and importance of the mortgage market.

At the end of 1987 there was $8.3 trillion of total credit market debt owed by consumers, non-financial business and government combined. Of this amount, $2.5 trillion was government debt, leaving just $5.8 trillion of private sector debt. The mortgage market was $2.9 trillion in size, of which $2.2 trillion was residential. By comparison, no other sector of the market comes close. It is five times the size of bank loans ($660 billion), four times the size of consumer credit ($760 billion). Whether mortgage investment is done through a separate industry called the thrift industry or through the banking system, the thrift function--funding mortgages with insured deposits--will persist as the largest and most important sector of the financial system.

> In a sense, deciding that we don't really need the thrift industry any more, is a little like deciding to get rid of the Atlantic Ocean. When you look for a place to put all that salt water, the only place that's large enough is the trench between the Americas and Europe. Financing mortgages with savings deposits...financing the consumer's home with a liquid instrument that doesn't place the consumer's principal at risk--is the thrift industry. J. Gray, Financial Deregulation and the Savings and Loan Crisis 1718 (Bernstein Research, December 27, 1988).

In testimony on March 10, 1989 before this Committee, the National Association of Homebuilders (NAHB) and the National Association of Realtors (NAR) endorsed the importance of the thrift industry and the FHLBanks to homebuilding and homeownership. The same point has been stressed by David Maxwell, Chief Executive Officer of Fannie Mae (FNMA). Mr. Maxwell's support for the thrift industry is all the more significant, since those who allege that thrifts are now irrelevant to homeownership base their position, in large part, on the theory that FNMA and its sister agencies have rendered thrifts obsolete.

In this connection, it is interesting to reflect that it was the policy of Congress for many years to give the thrift industry the opportunity to offer a modestly higher rate for savings than commercial banks. The purpose of this differential was to be sure that thrifts could attract funds which they would then use for long-term home mortgage loans. The Administration Proposal does just the opposite. It penalizes the home mortgage business. Surely that is unintentional given the continued great need to house Americans.

VI. CONCLUSION

How many times during these hearings has the Committee been confronted with one of the major causes of today's problems: Unplanned, bungled deregulation? It's a certainty that the subject must surface again and again because:

- The legislative body of the U.S. Government played a major role in deregulation; and
- Had the process been handled in a judicious, intelligent, planful way--with careful analysis, guidelines, and checks and balances -- there would be no current need to discuss the astronomical losses experienced by the savings and loan industry and the future outlook for the business.

Today the Administration's Proposal marks another watershed event for the savings and loan industry, and, as a result, for housing, for the banking system, and for the tens of millions, if not hundreds of millions, of consumers who will be impacted. The revisionary proposals have been put together in a compressed period of time, preceded by several ill-thought out trial balloons. The Proposal itself is flawed, reflecting the inadequate analysis on which the plan is based.

It was the philosopher George Santayana who said:

> Those who cannot remember history are condemned to repeat it.

Except for recent Administration appointees, most people who are close to the industry today must have a vivid memory of events of the last 10 years. The fatal errors are very clear. Those who made them can either learn from the past or repeat it.

The nature and structure of the savings and loan industry are about to be revised. Will the task be undertaken in a planful, intelligent way? Will the perspective be long term, or will politically expedient, short term considerations prevail? And most important, will we find ourselves five to ten years from now discussing the unplanned, bungled 1989 restructure of the savings and loan business, the demise of the industry, and the overwhelmingly expensive consequence of the flawed process? And will the cost of that scandal be $50 billion, $100 billion or $250 billion?

When will we ever learn?

APPENDIX 1

Ten Important Facts About the Federal Home Loan Banks
(all data as of 12/31/88)

1. FHLBank assets: $175 billion
2. FHLBank loans to S&Ls: $153 billion
3. FHLBank capital: $15.5 billion
4. FHLBank debt: $136 billion
5. FHLBanks' purpose is to promote economical home finance by making loans to S&Ls
6. FHLBanks are owned by S&Ls
7. FHLBanks have no government or taxpayer money
8. FHLBanks borrow in the capital markets
9. FHLBanks need impeccable credit
10. FHLBanks do not regulate S&Ls

APPENDIX 2

Excerpts from The Federal
Home Loan Banks and the
Home Finance System,
published in
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The Federal Home Loan Banks and the Home Finance System

By Dirk S. Adams and Rodney R. Peck***

The Federal Home Loan Banks ("Banks") were established by the Federal Home Loan Bank Act of 1932 ("FHLB Act")[1] to provide savings institutions with their own specialized and flexible source of wholesale funds in furtherance of this nation's policy of providing economical home financing.[2] In the intervening half century, the Banks have successfully fulfilled that mission by making billions of dollars of secured loans to savings institutions, which in turn have lent the money primarily for home mortgages. During this era, home ownership in the United States has flourished. In the 1930s, approximately forty-two percent of American homes were owner-occupied. By 1987, sixty-five percent of American households had fulfilled the American dream of home ownership, and forty percent of those homes were financed by thrift institutions.[3] The Federal Home Loan Banks have been the linchpin of this mortgage lending machine.

Now with the thrift system again in crisis and federal lawmakers actively considering a variety of structural changes to revive the system, the strength and agility of the Federal Home Loan Banks are being tested. Their survival will depend upon their ability to once again demonstrate their value and upon the thrift industry's recognition of that value.

There are twelve District Banks in the Federal Home Loan Bank System, each serving its own geographical area. The Banks presently are located in Boston, New York, Pittsburgh, Atlanta, Cincinnati, Indianapolis, Chicago, Des Moines, Dallas, Topeka, San Francisco, and Seattle. The Banks are one of three major components of the Federal Home Loan Bank System. The other

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[1] 12 U.S.C.A. §§ 1422–1449 (1957 & Supp. 1987).

[2] 12 U.S.C.A. § 1425a(a) (West Supp. 1987).

[3] U.S. League of Savings Institutions, Savings Institutions Sourcebook (1987).

components are the Federal Home Loan Bank Board ("FHLBB") and the Federal Savings and Loan Insurance Corporation ("FSLIC"), both independent agencies of the United States government.

The Federal Home Loan Banks constitute an essential financial resource for the United States thrift industry, the latter composed of the approximately 3,000 member savings institutions chartered under either the laws of the various states or by the federal government under the Home Owners' Loan Act of 1933.[4] As of June 30, 1987, the twelve Federal Home Loan Banks had combined total assets of $137.6 billion, combined outstanding loans (called "advances") to member savings and loan associations of $114.3 billion, outstanding consolidated debt obligations of $99.7 billion, and total equity capital, including reserves, of $13 billion. Aggregate net income for the year ending December 31, 1986, was $1.4 billion and for the six months ending June 30, 1987, was $669 million.[5] On the basis of their combined total assets of $131.4 billion as of December 31, 1986, the Banks would have constituted on that date the second largest commercial banking institution in the United States[6] and the fifteenth largest commercial banking institution in the world.[7] On the basis of their aggregate tangible net worth of $11.7 billion on that date, they would have been the strongest banking institution in the world.[8] The Banks have never suffered a credit loss.

This paper will discuss the development and basic elements of the Federal Home Loan Bank System, including a review of the evolution of the system, the nature of the corporate structure and ownership of the Federal Home Loan Banks, and the role of Bank employees in supervising and examining savings institutions that are member-shareholders of the Banks. This paper also will outline the credit and other services presently furnished by the Banks to member thrifts and discuss the key role the Banks will play in the recapitalization of the FSLIC and in meeting the challenges now facing the savings industry.

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[4] 12 U.S.C.A. §§ 1461–1470 (1980 & Supp. 1987).

[5] Telephone interview with Sarah Drake, Supervisor—Consolidated Obligations Operator, FHLBB Office of Finance, Washington, D.C. (Sept. 1, 1987).

[6] Telephone interview with Carol Edwards, Supervisor—Financial Planning Division, FHLBB Office of Finance, Washington, D.C. (Sept. 1, 1987); Board of Governors of the Fed. Reserve Sys., Selected Information on Insured U.S. Commercial Banks with Consolidated Assets of $100 Million or More (Mar. 31, 1987).

[7] *American Banker Statistics Review: The World's Top 500 Banks by Assets*, 152 Am. Banker, July 31, 1987, at 27–37.

[8] Telephone interview with Dale Markowski, Staff Accountant, FHLBB Office of District Banks, Washington, D.C. (Oct. 28, 1987); Brody, *The Biggest Banks Outside the U.S.*, 116 Fortune, Aug. 3, 1987, at 242, 243–44.

DEVELOPMENT AND BASIC ELEMENTS OF THE FEDERAL HOME LOAN BANK SYSTEM –

ORIGINS AND EVOLUTION OF THE SYSTEM

The first savings and loan associations and mutual savings banks were established in the early 1800s as the United States began its evolution from an agricultural to an urbanized society. Urbanization generated increased needs for home financing and consumer savings depositories. Savings institutions developed to meet this need as commercial banks concentrated on agricultural and commercial lending. The early thrifts charged no interest on loans and determined their members' eligibility for loans by holding drawings. More institutions concentrating in home loans were soon established, as building associations, land associations, cooperative banks, building and loan associations, and homestead associations formed to meet the demand for housing loans. In time, these associations began auctioning loans to the highest bidding members and charging interest. As these institutions increased in number and size, many states enacted laws for chartering and supervising thrifts. In 1893, there were over 5,800 savings institutions with nearly 1.8 million shareholders and more than 450,000 borrowers. The assets of these institutions totaled about $529 million. By 1932, when the Federal Home Loan Bank System was established, the industry had grown to more than 11,400 institutions with total assets of $8.4 billion.[9]

As the early thrift industry grew, various problems emerged. These included lack of adequate means for transferring surplus funds for capital investment from one geographic area to another to meet regional home financing needs, lack of access to national capital markets, and absence of a central credit facility to enable mortgage lending institutions to meet seasonal or other changes in loan demand or savings supply. The prosperity of the 1920s obscured the problems in the home finance industry, but the Great Depression brought them into sharp focus. As a result of mortgage loan defaults, declines in the value of collateral, and heavy savings account withdrawals, 1,700 savings institutions failed in the early years of the Depression. In response to this liquidity crisis, President Hoover signed the FHLB Act into law on July 22, 1932.[10] The Banks were to make loans on the collateral of mortgages, thereby liquifying thrifts' portfolios and enabling them to meet withdrawals.

By 1933, forty percent of the nation's $20 billion in outstanding home mortgage loans were in default. It became clear that the Banks by themselves were not a sufficient response to this crisis, so Congress enacted the Home Owners' Loan Act of 1933 ("HOLA").[11] HOLA contained provisions for granting federal charters to savings and loan associations for the first time; it also created the Home Owners' Loan Corporation ("HOLC"). HOLC's purpose was to strengthen the financial condition of home lenders and to provide more flexible loan terms to existing borrowers. Lenders exchanged delinquent mortgage loans for HOLC bonds and the borrowers then refinanced their loans with HOLC on more liberal terms. After completion of its mission, HOLC was liquidated in 1951.[12] The effect of the FHLB Act and HOLA was to help meet the liquidity crisis being suffered by thrifts during the Depression by supplying credit secured by performing mortgages and by providing a buyer for thrifts' delinquent mortgages.

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[9] *See generally*, FHLBB, A Guide to the Federal Home Loan Bank System (P. Lockwood author, 5th ed. 1987).

[10] *Id.* at 8.

[11] 12 U.S.C.A. §§ 1461–1470 (1980 & Supp. 1987); FHLBB, *supra* note 9, at 9.

Having increased the liquidity supply, Congress moved to reduce the demand for liquidity through enactment of the National Housing Act of 1934 ("NHA") which established the FSLIC.[13] The FSLIC provided savings and loan associations with deposit insurance benefits comparable to those provided to commercial banks by the Federal Deposit Insurance Corporation.[14]

The FHLB Act also established the Federal Home Loan Bank Board as an independent agency of the federal government.[15] The FHLBB panel is now composed of three members who are appointed by the President with confirmation by the Senate, to serve full or unexpired portions of four-year terms.[16] The President designates one member as chairman.[17] No more than two FHLBB members may belong to the same political party.[18] The FHLBB is self-supporting and uses no tax revenues; its operating costs are funded by assessments on the District Banks and the FSLIC.[19] The FHLBB oversees the operation of the twelve Banks, grants federal charters to savings and loan associations and mutual savings banks, and regulates all such federally chartered institutions. The FHLBB members direct the FSLIC (which in turn regulates all FSLIC-insured savings institutions) and are directors, as well, of the Federal Home Loan Mortgage Corporation.[20]

[12] FHLBB, *supra* note 9, at 9–10.

[13] 12 U.S.C.A. §§ 1701–1750g (1980 & Supp. 1987).

[14] FHLBB, *supra* note 9, at 10–11.

[15] 12 U.S.C.A. § 1437 (1957 & Supp. 1987).

[16] 12 C.F.R. § 500.10 (1987).

[17] *Id.*

[18] *Id.*

[19] 12 U.S.C.A. § 1438 (1957 & Supp. 1987); FHLBB, *supra* note 9, at 25.

[20] The Federal Home Loan Mortgage Corporation ("Freddie Mac") was created by the Emergency Home Finance Act of 1970 to establish a secondary market for conventional home mortgages. Freddie Mac's common stock is held by the Federal Home Loan Banks and its participating, preferred, nonvoting stock is held by members of the Banks. Freddie Mac is a federal corporate instrumentality, but it uses no tax funds. Freddie Mac buys mortgages from original lenders and sells investment securities backed by those mortgages. Freddie Mac's securities are more valuable than the original mortgages because they are more liquid and more marketable and spread the risk over a large pool of mortgages. *See* FHLBB, *supra* note 9, at 57.

DUAL NATURE OF THE FEDERAL HOME LOAN BANKS

Because the Hoover Administration was influenced by the post-World War I Associationist Movement, the FHLB Act contains certain components of industrial self-policing favored by that movement.[21] Indeed, but for that understanding of their origins, modern-day observers could consider the Banks to be peculiar creations with unique structures. Each Bank is a federally chartered, privately owned corporation, which performs two basic functions: (i) It provides wholesale banking services, and (ii) certain of its personnel supervise and regulate, on behalf of the FSLIC, the institutions that are members of the Bank and also are FSLIC-insured. The former is authorized by the FHLB Act[22] and the latter delegated to certain Bank employees (but not to the Bank itself) by the FHLBB, again, pursuant to the FHLB Act.[23] The purpose of the banking function is to make secured advances[24] to creditworthy members, normally in furtherance of their housing finance mission. The regulatory function, on the other hand, acts to assure the safety and soundness of FSLIC-insured savings institutions. While obviously some of the indicia of creditworthiness and safety and soundness are similar, these two standards are not interchangeable. As a consequence, these two functions, banking and regulatory, although housed in the same corporate body, are distinct and are so treated by the Banks.

CORPORATE STRUCTURE AND OWNERSHIP OF THE BANKS

Although some Bank employees act on behalf of the FHLBB in its regulatory capacity, the Banks are owned by their members. Each FSLIC-insured savings institution is required to purchase stock in its District Bank.[25] In the parlance of the FHLB Act, shareholders are called "members,"[26] again reflecting the Associationist Movement. FDIC-insured savings banks may, but are not required to, become members and purchase stock as well.[27] In most cases, the location of a potential member's principal place of business determines which District Bank the member must join.[28]

The amount of stock each member must purchase is based on the amount of the member's investments in residential real estate mortgages and the amount of its Federal Home Loan Bank advances. The stock held by a member must be at least one percent of the unpaid principal balance of loans the institution has made to finance residential real estate (including mortgages and mortgage-backed securities) based on the institution's portfolio at year-end.[29] Also, a member must acquire more stock whenever its outstanding advances from its Federal Home Loan Bank exceed twenty times the amount of stock the institution holds in the Bank.[30] Since the first issue of Federal Home Loan Bank stock in 1932, the price of the stock has remained at $100 per share.[31] Purchases of capital stock in excess of these minimums are not expressly prohibited by statute, and most Banks have developed guidelines permitting such purchases.

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[21] T. McCraw, Prophets of Regulation 147–49 (1984).

[22] 12 U.S.C.A. § 1431(e) (1957 & Supp. 1987).

[23] 12 U.S.C.A. § 1437 (West Supp. 1987).

[24] 12 U.S.C.A. § 1430(a) (West Supp. 1987).

[25] 12 U.S.C.A. §§ 1424, 1426.

[26] 12 U.S.C.A. § 1422 (1957 & Supp. 1987).

[27] 12 U.S.C.A. §§ 1424, 1426 (1957 & Supp. 1987).

[28] 12 U.S.C.A. § 1424(b)

Stock ownership carries with it two basic rights. The first is to receive any dividends declared on the stock.[32] In 1986 the average annual dividend for the Banks was 10.6%.[33] Dividends paid by the Banks to their members vary from time to time and from one Bank to another, depending upon the profitability of each Bank and upon prevailing economic conditions. Dividends are typically declared in the form of stock and probably are not taxable until the stock is redeemed.[34] An owner of stock, or member, also has the right to vote for a nominee to the board of directors of the Bank. This nominee must represent a member located in the same state as the member voting.[35] Each share carries one vote, but no member may vote more shares than are equal to the average number of shares required to be held in the Bank by the members of that Bank located in the same state as the voting member.[36] As an attempt to prevent a large shareholder from having an undue impact on the election, this limitation helps to equalize the rights of members.

Besides these two rights, the attributes of share ownership are very limited. This is made clear by the relevant statutory provisions[37] and by the decision of the U.S. Court of Appeals for the Ninth Circuit in the seminal case on the issue, *Fahey v. O'Melveny & Myers*.[38] In that case, the court held that the Banks are federal instrumentalities organized to carry out public policy, that their members are only nominally shareholders and that neither the Banks nor their shareholders possess "any of the purely inherent characteristics and attributes of orthodox private corporate business enterprises."[39] Thus, the court held that the FHLBB could dissolve a Bank and transfer all the members' capital stock in that Bank to another Bank over the objection of the members of the former Bank.

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[29] 12 U.S.C.A. § 1426(c).

[30] 12 U.S.C.A. § 1426(c)(2) (West Supp. 1987).

[31] FHLBB, *supra* note 9, at 41.

[32] 12 U.S.C.A. § 1426(k) (1957).

[33] Telephone interview with John Curtis, Financial Analyst, FHLBB Office of District Banks, Washington, D.C. (Sept. 1, 1987).

[34] See Frontier Sav. Ass'n and Subsidiaries v. Commissioner, 87 T.C. 665 (1986).

[35] 12 U.S.C.A. § 1427(b) (West Supp. 1987).

[36] 12 U.S.C.A. § 1427(b).

[37] 12 U.S.C.A. §§ 1426, 1427.

[38] 200 F.2d 420 (9th Cir. 1952).

[39] *Id.* at 446.

DIRECTORS OF THE BANKS

Normally, there are fourteen members on a Bank's board of directors, broken into two categories—elected directors and FHLBB appointed directors.[40] In a Federal Home Loan Bank district, which includes five or more states, the FHLBB may increase the elected directors to a number not exceeding thirteen and may increase the appointed directors to a number not exceeding three-fourths of the number of elected directors.[41] The shareholders of each Bank elect a majority of their Bank's board of directors.[42] The FHLBB appoints the balance of the members of the board of directors, known as public interest directors.[43] Each elective directorship is designated by the FHLBB as representing Bank members of a particular state, and only officers or directors of a member located in that state are eligible to be directors.[44] Appointed directors typically are not associated with member institutions.[45] Appointed directors, however, normally have familiarity with the thrift industry through experience in real estate-related activities, the practice of a related profession, or service with educational institutions. Elected directors serve for a two-year term and may be elected to three consecutive terms.[46] Appointed directors serve a four-year term.[47] There is no statutory limitation on the number of terms an appointed director may serve, although normally changes in FHLBB administrations result in changes in these positions after one or two terms.

By statute, the directors are responsible for administering the affairs of the Bank.[48] Two of the key responsibilities in this regard are the approval of the Bank's credit policy and the implementation of that policy. The Bank is directed by law to extend to borrowers only such credit "as may be made safely and reasonably."[49] In addition to administering the affairs of the Bank fairly and guiding its credit program, the board of directors also has the responsibility to direct the Bank so that it complies with the FHLB Act and the regulations under it.[50]

Although some Bank employees act on behalf of the FHLBB and the FSLIC, Bank directors have no responsibility or liability for such activities.[51] This conclusion is confirmed by the FHLBB's regulations, which are consistent with the terms and provisions of the FHLB Act and its long-standing interpretation by the Office of General Counsel of the FHLBB.[52] Similarly, it is the FHLBB, and not the Banks or their directors, that is vested with the responsibility for the administration and enforcement of the HOLA and the NHA.[53] In addition to having no statutory or regulatory duty to review or participate in the supervision or examination of member institutions, under the regulations of the FHLBB adopted pursuant to the Freedom of Information Act,[54] the directors of a Bank (without approval of the FHLBB) are not permitted to have access to information of the FHLBB, including information contained in examination reports, that the FHLBB has determined is confidential.[55] In practice, the FHLBB does not normally furnish such information to the directors. Certain officers of a Bank, however, are permitted access to such information.[56] Interestingly enough, the FHLB Act does authorize the Banks independently to examine their members,[57] a power rarely used. Presumably, this power was conferred in recognition of the credit functions of the Banks, although it is another hint of the Banks' cooperative nature.

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[40] 12 U.S.C.A. § 1427(a) (West Supp. 1987).

[41] 12 U.S.C.A. § 1427(a).

[42] 12 U.S.C.A. § 1427(b).

[43] 12 U.S.C.A. § 1427(a).

[44] 12 U.S.C.A. § 1427(b).

[45] *See* FHLBB Office of District Banks, Federal Home Loan Banks Guidelines for Board-Appointed Directors (Public Interest) (1982).

[46] 12 U.S.C.A. § 1427(d) (West Supp. 1987).

[47] 12 U.S.C.A. § 1427(d).

[48] 12 U.S.C.A. § 1427(j) (1957 & Supp. 1987).

[49] 12 U.S.C.A. § 1427(j).

[50] 12 C.F.R. § 522.61 (1987).

[51] *Id.* at § 522.62.

Indemnification of directors, officers, and employees of Federal Home Loan Banks is governed by FHLBB regulations and by provisions in the by-laws of each of the District Banks. Pursuant to the FHLBB regulations, directors, officers, and employees of the Banks are, under certain circumstances, entitled to indemnification for the amount of any judgment and reasonable costs and expenses (including reasonable attorneys' fees), paid or incurred by such persons in defending or settling any action brought or threatened against them in their capacities as directors, officers, or employees of the Banks.[58] Such indemnification is only mandatory if there is a final judgment in the indemnitee's favor, or if the FHLBB approves indemnification based on the District Bank's board of directors' determination that certain good faith and reasonableness requirements have been met.[59] These requirements are similar to those applicable to Federal Reserve Bank directors.[60]

The FHLBB regulation governing indemnification of District Bank directors is generally similar to the FHLBB regulation governing indemnification of directors of federally chartered savings and loan associations.[61] However, the role of Federal Home Loan Bank directors in furthering public policy suggests that they should benefit from broader indemnification rights than their counterparts in the private sector. The actions of Federal Home Loan Bank directors have far-reaching effects which may expose them to greater threats of unmeritorious litigation than faced by savings and loan association directors.

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[52] *Id.*; Opinion of Office of General Counsel of FHLBB (May 26, 1970) ("The Federal Home Loan Banks have no authority to supervise or examine the activities of their members. These activities are carried on by [FHLBB] under the authority of the Home Owners' Loan Act and National Housing Act and do not concern the Banks. . . .

. . . .

. . . 'The bank directors . . . have *no* authority with respect to processing or making recommendations on matters such as applications for mergers, branch offices, permission to organize, and insurance of accounts.' ").

[53] 12 C.F.R. §§ 500.1, 500.4 (1987).

[54] 5 U.S.C.A. § 552 (1977 & Supp. 1987).

[55] *See* 12 C.F.R. § 505.5 (1987).

[56] *Id.* at § 505.5(c) (1987).

[57] *Id.* at § 523.20 (1987). *See also* 12 U.S.C.A. § 1430(b) (1957 & Supp. 1987).

[58] 12 C.F.R. § 522.72 (1987).

[59] *Id.* at § 522.72(c) (1987).

[60] *See* 1975 Conference of Chairmen and Deputy Chairmen of the Federal Reserve Banks, Statement of Policy on Indemnification of Directors of Federal Reserve Banks (May 30, 1975)

LITIGATION INVOLVING THE BANKS AND BANK DIRECTORS

The seminal case on whether members may properly assert a claim against a Bank for actions taken by its directors is *Fidelity Fin. Corp. v. Federal Home Loan Bank of San Francisco*.[62] In *Fidelity*, the Ninth Circuit affirmed a district court's final judgment in favor of the Federal Home Loan Bank of San Francisco in an action brought by the parent corporation of Fidelity Savings and Loan Association ("Fidelity") alleging that the Bank's denial of an application by the association to obtain short-term credit advances was wrongful. Fidelity alleged that the Bank's denial of regular credit to the association violated procedural due process and common law fiduciary duties owed by the Bank and its directors to Fidelity. The district court dismissed the procedural due process claim and granted summary judgment for the Bank on the fiduciary duty claim, ruling that Fidelity had presented no evidence that the Bank's credit decisions were in bad faith, were grossly negligent, or otherwise represented a breach of any duty by Bank directors.

The Ninth Circuit Court of Appeals affirmed the district court's finding that Fidelity had no protectable property interest in receiving regular credit advances and, therefore, had no claim of a violation of its fifth amendment right to due process. With respect to Fidelity's claim that the Bank and its directors owed it a federal common law fiduciary duty, the Ninth Circuit went beyond the rationale of the lower court and rejected the legal theory upon which the claim was based. It noted that the circumstances in which federal courts may formulate federal common law are "few and restricted" and that there was no congressional authorization for federal courts to formulate substantive rules of decision regarding the Federal Home Loan Banks' and their directors' liability to a member.[63] As a consequence, neither the FHLB Act nor federal common law permits members to sue Bank directors.

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[61] 12 C.F.R. § 545.121 (1987).

[62] 792 F.2d 1432 (9th Cir. 1987).

[63] *Id.* at 1437. Earlier, the lower court had ruled that the pertinent provisions of the FHLB Act on the extension of credit, § 7 of the Act, did not create an implied right of action in favor of the member (Fidelity Fin. Corp. v. Federal Home Loan Bank of San Francisco, 589 F. Supp. 885, 891 (N.D. Cal. 1983)). The result of this decision, together with the Ninth Circuit decision, is that a disgruntled member may not sustain an action against a Bank or a Bank director on either an implied right of action or a federal common law theory. (*See infra* note 64 for a discussion of how a member may seek recourse.)

the "Federal Government" or the "United States" under various acts relating to government contracts, certain terms regarding wages, working conditions, bidding, approvals, and other matters must be included in certain contracts entered into by the Banks.[106] As a consequence of the Banks' sometimes ambiguous status, the applicability of any state or federal law to a Bank requires careful consideration.

MEMBER SERVICES

CREDIT ACTIVITIES OF THE BANKS

The primary mission of the Federal Home Loan Banks is to provide a reliable source of credit for their members.[107] Each Bank is authorized to make advances upon such security as the FHLBB may prescribe.[108] Although the regulations permit a Bank to grant a very modest amount of advances without security,[109] a Bank usually will not make such advances. Credit is granted pursuant to the terms of a Bank's credit policy, which must be reviewed semiannually by the Bank's board of directors.[110] Within the parameters set by the relevant statute and the FHLBB, credit policies vary among the twelve Banks. Advances are made on the note or obligation of the member and are made subject to the terms of a loan and security agreement between the Bank and the member. The interest rate on the advances is set by the Bank's board of directors subject to ranges established by the FHLBB.[111] Subject to approval by the FHLBB, a District Bank may sell its advances to another District Bank or allow another Bank to participate in its advances.[112]

Typically, a Bank grants credit after underwriting a member's creditworthiness. The relevant statutory provision provides that credit shall be extended only if it can be done safely and reasonably with due regard (i) for the claims and demands of other institutions and (ii) for the maintenance of adequate credit standing for the Bank and its obligations;[113] it further makes clear that the Bank can deny any application for credit.[114] The FHLBB has declared that advances may be denied if a member-applicant engages in unsafe or unsound practices, has inadequate regulatory capital, is sustaining operating losses, or otherwise suffers from financial or managerial deficiencies.[115] A

Webster County Coal Corp. v. Tennessee Valley Auth., 476 F. Supp. 529 (W.D. Ky. 1979) (Tennessee Valley Authority, as an agency and instrumentality of the federal government, is immune from liability under antitrust laws).

[106] *See, e.g.*, 41 U.S.C.A. § 5–58 (1987).

[107] 12 C.F.R. § 531.1(a) (1987).

[108] 12 U.S.C.A. § 1430(a) (1957 & Supp. 1987).

[109] 12 U.S.C.A. § 1431(g); 12 C.F.R. § 525.10 (1987).

[110] 12 C.F.R. § 525.2 (1987).

[111] 12 U.S.C.A. § 1430(c) (1957 & Supp. 1987).

[112] 12 U.S.C.A. § 1430(d) (1957).

[113] *See* 12 C.F.R. § 531.1(a) (1987).

[114] *Id.* at § 531.1(d); 12 U.S.C. § 1429 (1957).

[115] 12 C.F.R. § 531.1(d) (1987).

member that desires an advance that does not conform with a Bank's credit policy may seek an exception from the Bank's board of directors.[116]

In the one published judicial decision to consider this statutory scheme for making advances, the Ninth Circuit Court of Appeals held, in *Fidelity Financial Corp. v. Federal Home Loan Bank of San Francisco*,[117] that the FHLB Act does not impose "particularized standards or criteria that significantly constrain the Bank's discretion to deny or condition advances."[118] The lower court in the same case found that the Bank had "plenary discretion" in deciding whether to extend credit.[119]

Thrifts may use advances for any purpose consistent with the promotion of home financing.[120] Permitted uses include making and purchasing residential mortgage, consumer, and commercial loans; covering savings withdrawals; accommodating seasonal cash needs; restructuring liabilities; and maintaining adequate liquidity.[121] Advances may be made for periods of up to twenty years.[122]

While varying somewhat among districts, acceptable collateral must fall within the following general types: (i) first mortgages on homes; (ii) U.S. Government, Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, or Government National Mortgage Association securities; (iii) deposits at a District Bank; or (iv) other property which is acceptable to the Bank, provided that the property has a readily ascertainable value and the Bank can perfect a security interest in it.[123] As a consequence, most Federal Home Loan Bank advances are secured by either government or agency securities or home mortgages. Other types of security, such as consumer loans or commercial real estate mortgages, are usually accepted, if at all, in only very modest quantities. Further, the stock that each member must purchase in a Bank is subject to a statutory first lien to secure all advances to that member.[124] The amount of collateral necessary to secure an advance is determined by each Bank's credit policy but is normally some percentage in excess of 100% of the advance, calculated using either the outstanding principal balance of the pledged mortgage loans or their estimated fair market value.[125]

At one time, the FHLBB required that all collateral be physically delivered to the District Banks.[126] At present, most members are permitted to hold the collateral in trust for the Bank making advances to them until such time as the member becomes subject to a collateral delivery requirement (usually when total capital falls below a certain percentage of total liabilities). Pursuant to section 306 of the Competitive Equality Banking Act of 1987,[127] section 10 of the FHLB Act[128] was amended to provide that notwithstanding any other provision of law (presumably state or federal), any security interest granted to a Federal Home Loan Bank by any member or affiliate thereof is entitled to priority over the claims and rights of any party (including any receiver, conservator, trustee, or similar party having rights of a lien creditor). The only exceptions to this lien priority are liens that would be entitled to priority under otherwise applicable law *and* are held by actual bona fide purchasers for value or secured parties that are secured by an actual perfected security interest.[129] The intent of this provision is to protect the lien of the Banks upon the borrower's insolvency and the appointment of a receiver or other custodian for the member. The provision is also intended to prevent any other creditors from obtaining priority with respect of the same collateral except those creditors who did not have notice of the Bank's security interest and who actually took possession of or otherwise actually perfected a lien on the same collateral (e.g., by filing a Uniform Commercial Code financing statement if the collateral is such that a filing can perfect a lien on it). This new provision was adopted in recognition of the difficulty of obtaining physical possession of large amounts of mortgage loan collateral in a short period of time (the likely challenge confronting a Bank extending credit to a member who suddenly experiences a dramatic drop of net worth into insolvency), and in recognition that the Banks may serve, in effect, as lenders of last resort to their members.[130]

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[116] Fidelity Fin. Corp. v. Federal Home Loan Bank of San Francisco, 589 F. Supp. 885, 889 (N.D. Cal. 1983).

[117] Fidelity Fin. Corp. v. Federal Home Loan Bank of San Francisco, 792 F.2d 1432 (9th Cir. 1987).

[118] *Id.* at 1436.

[119] *Fidelity*, 589 F. Supp. at 897.

[120] FHLBB, *supra* note 9, at 43.

[121] 12 C.F.R. § 531.1(c) (1987).

[122] *Id.* at § 525.6.

[123] *Id.* at § 525.7(b).

[124] 12 U.S.C.A. § 1430(c) (1957 & Supp. 1987).

[125] *See, e.g.*, Federal Home Loan Bank of San Francisco, Credit Program 1:29 (July 1, 1987).

[126] FHLBB, *supra* note 9, at 44.

In addition to advances to members that are collateralized in the normal course, the Banks also make advances to members that are guaranteed by the FSLIC[131] and are authorized to make advances to the FSLIC directly.[132] While practices among the Banks vary somewhat, typically a Bank seeks an FSLIC guarantee of a member's advances either when a member is insolvent or when the member has inadequate eligible collateral to secure its advances.[133] Shortly before Congress authorized FSLIC's recapitalization, one Federal Home Loan Bank, reacting to press reports on the FSLIC's financial condition, reportedly demanded payment on one of its guarantees although the member was not in default as to its payment obligations.[134] Presumably, with its recapitalization, the FSLIC will not soon hear such demands again. If the advances it is guaranteeing are not adequately collateralized, the FSLIC will reserve for the guarantee on its financial statement.[135]

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[127] Competitive Equality Banking Act of 1987, Pub. L. No. 100–86, 101 Stat. 552–663 (1987).

[128] 12 U.S.C.A. § 1430 (1957 & Supp. 1987).

[129] Pub. L. No. 100–86, § 306(d), 101 Stat. 552, 601 (1987).

[130] H.R. Rep. No. 261, 100th Cong., 1st Sess. 162–63 (1987), *reprinted in* 1987 U.S. Code Cong. & Admin. News 588, 632.

[131] 12 C.F.R. § 531.2(a) (1987).

[132] *Id.* at § 531.2(b).

[133] *See, e.g.*, Federal Home Loan Bank of San Francisco, Credit Program, *supra* note 125, at 1:12, 1:31.

[134] *FSLIC Backs Up Guarantees With Cash Payment of $1 Billion to Dallas FHLBank*, 48 Banking Rep. (BNA), Mar. 23, 1987, at 501.

To date, advances to the FSLIC have been made solely in connection with its sale of failed thrifts to buyers that also are members of the Home Loan Bank system. In these transactions, certain District Banks have extended credit to the FSLIC at the Banks' prevailing rates, and the FSLIC has, in turn, loaned this money at a lower rate to the acquiror.[136] The acquiror collateralizes these loans, and the FSLIC also pledges this collateral to secure its Bank borrowings.[137] The net effect is that the acquiror receives, through FSLIC assistance, Bank advances at more favorable terms than it could borrow itself. The Banks and the FSLIC also have explored, though not implemented, extensions of secured credit to FSLIC for its general use without reference to any particular acquisition transaction.[138]

ROLE OF FEDERAL HOME LOAN BANK CREDIT IN STOPPING 1984 LIQUIDITY CRISIS AT AMERICAN SAVINGS

The August 1984 liquidity crisis at American Savings and Loan Association in Stockton, California ("American"), demonstrates one of the main contributions that the Federal Home Loan Banks can render to the housing finance system. At the time, American was the largest thrift in the United States, with approximately $33 billion in assets. As a result of a requirement imposed by the Securities and Exchange Commission that American's holding company, Financial Corporation of America ("FCA"), restate its financial results from certain mortgage securities trading activities, FCA announced on August 15, 1984, a loss of $107.5 million for the second quarter of 1984. This triggered massive withdrawals of jumbo deposits over the next several weeks.[139] In the third quarter of 1984, American lost $6.8 billion in deposits.[140] This should be compared with the experience of Continental Illinois National Bank and Trust Company, which suffered a $10 billion deposit run over three months. The Federal Reserve met the Continental run by lending $7.5 billion in emergency loans and reorganizing the bank and its holding company, which left very little of the interests of its holding company's public shareholders intact.[141] American, or provide on-line data processing services,[167] on the ground that such activities are not incidental to home financing purposes—the Banks' primary mission. However, the Banks do have clear authority to provide several different types of services to their members in addition to providing advances, swaps, and letters of credit.

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[135] *See* Federal Savings and Loan Insurance Corporation, Comparative Statement of Financial Condition as of December 31, 1986 and 1985, Notes to Financial Statements, nn.1, 2 at 91, nn.4, 6 at 92.

[136] *See* McTague & Garsson, *District Bank Forcing Thrifts to Borrow Directly from FSLIC,* 152 Am. Banker, Mar. 18, 1987, at 1.

[137] *Id.*

[138] *Id.*

[139] Hayes, *The Cash Squeeze at Financial Corp.*, N.Y. Times, Aug. 17, 1984, at D1, col. 4.

[140] Hughes, *FCA Hopes Dip in Interest Rates Will Help in Bid to Lure Deposits, Achieve Turnaround,* San Francisco Examiner, July 5, 1985, at C-1, col. 1.

[141] *See* Koepp, *Betting Billions on a Bank; The Feds Come to the Rescue of Failing Continental Illinois,* Time, Aug. 6, 1984, at 48.

The principal ancillary service to Bank members is the furnishing of a variety of deposit products, including demand, overnight, term, and special series deposits as discussed further below.[168] In addition, the Banks provide extensive check processing and related services to their members pursuant to the authority found in section 11(e)(2) of the FHLB Act.[169] The Banks also act as trustees of trusts affecting their members' business[170] and hold mortgage loans and securities in safekeeping for their members.[171] Pursuant to section 8 of the FHLB Act, the Banks also furnish a variety of economic and analytical services and studies to members in order to assist in their loan financing and asset/liability management activities.[172]

At a member institution's request, a Federal Home Loan Bank will also act as a "pass-through correspondent" with respect to the member's Federal Reserve Bank deposit reserve requirements.[173] In this arrangement, the member's required reserves are maintained in an account at its District Federal Home Loan Bank, where they may be commingled with the reserves of other members of that Bank and the Bank's own reserves.[174] The District Bank is responsible for monitoring the sufficiency of the members' reserve levels and for periodic reporting to the Federal Reserve Bank in its district.[175]

SOURCES OF FUNDS

The Banks have three principal sources of funds: capital stock and retained earnings, deposits from members, and the sale of consolidated obligations in the public debt markets.[176]

Until the 1960s, the sale of additional shares of capital stock was a major source of funds for the District Banks. In more recent years, however, raising funds through the sale of consolidated obligations and through the deposit programs of the Banks has become much more important. The FHLB Act authorizes the District Banks to accept deposits from their member institutions.[177] The Banks may also accept deposits from nonmember institutions

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167. Association of Data Processing Serv. Orgs. v. Federal Home Loan Bank Bd., 568 F.2d 478 (6th Cir. 1977).

168. 12 U.S.C.A. § 1431(e) (West Supp. 1987).

169. 12 U.S.C.A. § 1431(e)(2) (West Supp. 1987); 12 C.F.R. pt. 534 (1987).

170. 12 C.F.R. §§ 524.5, 524.10 (1987).

171. *See id.* at §§ 524.9, 524.10.

172. 12 U.S.C.A. § 1428 (1957).

173. 12 C.F.R. § 204.3(i)(1) (1987).

174. *Id.* at § 204.3(i)(3)(i).

175. *Id.* at §§ 204.3(i)(2)(iii), 204.3(i)(4)(ii).

176. FHLBB, *supra* note 9, at 37–42.

177. 12 U.S.C.A. § 1431(e) (1957 & Supp. 1987).

eligible for membership, from other District Banks, and from other United States instrumentalities.[178] Deposit programs provide a significant portion of the Banks' financial resources and also assist the member institutions in meeting their regulatory liquidity requirements.

The types of deposit accounts available to the members include demand, overnight, term, and special series deposits.[179] Members use demand deposit accounts for processing savings withdrawals and mortgage loan disbursements. Overnight deposits earn daily interest and represent the largest portion of members' deposits. The overnight deposit account meets the members' needs for short-term investments and a depository for excess cash.

Term deposits, or certificates of deposit, are offered by the Banks at competitive market rates for periods of up to one and one-half years. Early withdrawal penalties attach to these deposits. Special series deposits permit thrift institutions that have money to lend to negotiate interest rates and other terms directly with other institutions that desire to borrow. The deposits are not redeemable prior to maturity and are deemed to be liquid assets.

The sale of consolidated bonds and notes, which are the joint and several obligations of the twelve Banks, has become the primary source of funds for the District Banks. These debt instruments are not obligations of the United States and do not carry any governmental guarantees. The FHLBB may not authorize the issuance of consolidated obligations in excess of twelve times the total paid-in capital and reserves of all of the Banks.[180] The Banks are required to carry, free from any lien or pledge, cash, obligations of or guaranteed by the United States, secured advances to members, and U.S. insured or guaranteed mortgages, in an amount not less than the total outstanding consolidated obligations.[181] Thus, the obligations are considered exceptionally safe securities. In many states, Bank obligations are legal investments for commercial banks, savings and loan associations, insurance companies, and other financial institutions as well as for executors, administrators, and other fiduciaries.[182] The tax status of the obligations is comparable to that of federal government debt issues. Income from the consolidated obligations is exempt from state and local taxation.[183]

The two types of Federal Home Loan Bank consolidated obligations are consolidated bonds and consolidated discount notes. The bonds are issued to satisfy the Banks' long-term funding requirements. The bonds typically mature from one to ten years from the date of issuance but may be for up to twenty years. Bond purchases are recorded in a book entry system maintained by the Federal Reserve Banks. Consolidated discount notes provide short-term funds for seasonal and cyclical fluctuations in savings flows and mortgage financing.

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[178] 12 U.S.C. § 1431(e)(1).

[179] *See generally* FHLBB, *supra* note 9, at 40–41.

[180] 12 C.F.R. § 506.1 (1987).

[181] *Id.*

[182] *See* FHLBB, *supra* note 9, at 38–39.

[183] 12 U.S.C.A. § 1433 (1957 & Supp. 1987).

These have maturities of up to one year and are evidenced by bearer certificates. The only source of return from investment in the discount notes is the gain realized upon their sale or redemption. The profit is treated as interest income for tax purposes.[184]

The Office of Finance, an administrative unit of the Banks headquartered in Washington, D.C. and controlled by the FHLBB, coordinates the financial activities of the District Banks and recommends an overall debt strategy.[185] The Office of Finance canvasses the Banks to determine when additional funds are required and each Bank's desired participation in a new issue. The Office of Finance also markets the consolidated obligations through a primary network of securities dealers and banks.[186] The primary network agents also maintain a secondary market for the obligations. Under certain circumstances, the FHLBB may authorize a private placement of the obligations.[187] Pursuant to the Government Corporation Control Act, the Secretary of the Treasury must approve such sales because the District Banks are considered "mixed ownership government corporations" (as opposed to wholly-owned), even though their stock is entirely owned by their members.[188] From time to time, consolidated obligations are offered in overseas markets.[189]

The investment departments of the Federal Home Loan Banks carry out the Banks' investment and hedging policies. The types of hedging transactions entered into have included purchase of Treasury securities, forward contracts on Treasury securities, Treasury bill, note and bond futures contracts, and Eurodollar futures contracts.[190]

BANK EMPLOYEES AS AGENTS OF THE FHLBB

The FHLB Act authorizes the FHLBB to delegate any of its responsibilities except rulemaking to employees or administrative units of the Federal Home Loan Banks.[191] It is important to note that the authorized delegations are *not* to the Banks, but rather to their employees. This statutory authorization for the FHLBB's use of the "borrowed servant" rule has been the basis for the modernization of the federal system for supervising and examining FSLIC-insured thrifts.[192]

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[184] *See* FHLBB, *supra* note 9, at 38–39.

[185] *Id.* at 35–36.

[186] *Id.*

[187] *Id.*

[188] 31 U.S.C.A. §§ 9101, 9108 (1983 & Supp. 1987).

[189] In February 1986, the FHLBB issued European currency consolidated obligations totalling $90 million and in April, 1986, issued a $140 million yen offering. Telephone interview with Dale Markowski, Staff Accountant, FHLBB Office of District Banks, Washington, D.C. (Oct. 28, 1987).

[190] Telephone interview with Arden Hall, Vice President, Financial Analysis, Federal Home Loan Bank of San Francisco, San Francisco, California (Oct. 28, 1987).

[191] 12 U.S.C.A. § 1437 (West Supp. 1987).

[192] Sun Oil Co. v. Dalzell Towing Co., 287 U.S. 291, 295 (1932).

APPENDIX 3

Excerpts from Golden West Financial Corporation Annual Reports for the Years 1980, 1985 and 1986

For the savings and loan business in general, results in 1980 were the worst in 50 years. While the extraordinary operating environment of the past year can be blamed for the extreme pressure on earnings, the real issues are more organic. Stresses on the industry were intensified principally for two reasons:

(1) The mismatch which exists in the length or term of assets and of liabilities, and

(2) The deregulation of liabilities without the deregulation of assets.

In the balance of these remarks, we will try to describe for you the problems created by the above two circumstances and to then discuss actions which must be taken to find the solutions.

Borrowing Short/Lending Long

Long-term mortgage loans represent the principal asset of savings and loan associations. Generally, these loans are made for a period of up to 30 years at interest rates that are fixed virtually for the entire term. A typical mortgage portfolio will still have loans made in the 1960s, when rates ranged between 5.75% and 8.25%, and a very large volume of 1970–1978 vintage, when rates were 7.25% to 10.00%. It is not surprising, then, that the overall yield on this major asset is low, certainly when compared with interest rates that have prevailed during the past few years. Of far greater consequence, however, is the sluggishness of the yield on the loan portfolio and the complete lack of sensitivity to changes in the interest rate environment.

There is a striking and disconcerting contrast between an association's major asset, mortgage loans, and its major liability, savings accounts. For the most part, deposits, which are the principal source of funds used to make loans, are short-term and pay rates that reflect returns currently available in the short-term money market. It is therefore not surprising to find that the industry's principal liability, savings accounts, possesses a high degree of responsiveness or sensitivity to changes in interest rates. While the structural imbalance of the savings and loan balance sheet—short-term liabilities supporting long-term assets—has been recognized and commented upon for decades, the situation only reached alarming proportions during the past few years.

The impact of the gap in the interest rate sensitivity that exists between mortgage assets and savings liabilities is graphically depicted in the chart on the previous page. Our loan portfolio yield increased only gradually as new loans at higher yields were added and as old, low rate loans were paid off. The cost of savings advanced far more rapidly, closely following movements in short rates, in this case represented by six-month Treasury Bills.

Liabilities Deregulated, But Not Assets

The severity of the imbalance we have just delineated was directly caused by financial regulators who moved to deregulate liabilities without deregulating assets in the same meaningful way. In June 1978, savings and loan associations were authorized to pay market rates for savings in the form of Money Market Certificates, savings accounts with interest tied to the discount rate on U.S. Treasury Bills of the same maturity. The popularity of these accounts and other market rate Certificates of Deposit has greatly exacerbated the rate sensitivity of the industry's liability structure.

Clearly, there is an urgent need to deregulate assets in the form of a contemporary mortgage instrument which is responsive to an association's cost of funds during the life of the loan. Regulatory efforts to date have only succeeded in authorizing variable interest loans with severe limitations on rate increases. For example, the current variable rate mortgage (VRM) and renegotiable rate mortgage (RRM) are restricted to maximum annual increases of 50

Herbert M. Sandler
Chairman of the Board and
Chief Executive Officer

basis points (a basis point is one hundredth of a percent), an obviously unrealistic limitation within the context of a 1980 environment in which yields on six-month U.S. Treasury Bills moved over 800 basis points.

The savings and loan industry must be permitted to make real estate loans with true interest rate variability which reflects the changes in the lender's cost of funds in a timely and responsive manner. Financial regulators are becoming increasingly aware of the exigency of the situation and, at this writing, are exploring a number of alternative approaches to the design of a new mortgage. We are optimistic that an instrument will be developed which will provide at least the first big step toward the correction of the savings and loan industry's structural imbalance.

Marion O. Sandler

Marion O. Sandler
President and
Chief Executive Officer

Louis J. Galen

Louis J. Galen
Vice Chairman of the Board

An Industry Divided

Companies fall into three categories now: those that are extraordinarily healthy, a middle group of legitimate operators that are not very profitable and another sector one might call the walking dead. They exist in name only. Their losses, when recognized, will be greater than their net worth. There are hundreds and hundreds of them, of all sizes.

"Talking Business with Sandler of Golden West Financial," *The New York Times*, Tuesday, September 3, 1985.

There can be no doubt that based on any objective measures, including profitability, interest rate risk control, asset quality, expense control, and net worth, Golden West Financial Corporation ranks among the top savings and loan institutions in the country. The purpose of this Annual Report is to make clear to stockholders the course of action that has been pursued to maintain Golden West in the first tier of companies. At the same time, it is instructive to pause briefly to explore the reasons why, given the same operating environment, there are institutions that are merely limping along and still others that are terminally ill. The discussion which follows involves not merely a brief lesson on how not to run a company, but also serves to focus attention on the outmoded insurance of accounts system under which both the savings and loan and commercial banking industries operate today.

Since their establishment over half a century ago, the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Deposit Insurance Corporation (FDIC) have charged premiums determined only by an institution's deposits, not upon the insured's capital strength or appetite for undertaking risk. While that method may have been appropriate in the structured environment which existed prior to the deregulation of the early 1980's, this approach is untenable based upon the latitude that banks and savings and loan associations now have to speculate with depositors' funds. High flying operations pay no more for account insurance than do their more prudent counterparts.

In testimony before a Congressional Committee, the Director, Office of Policy and Economic Research of the Federal Home Loan Bank Board (FHLBB), stated:

> ...undoubtedly, a large share of savings institution failures in recent years are at least partially attributable to the economic incentives for risk-taking posed by our current deposit insurance system.
>
> Statement before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, September 11, 1985.

The risk-taking referred to above involves the policies of excessive growth undertaken by certain segments of the savings and loan business. For example, throughout 1984, companies holding one-seventh of the industry's assets were growing at a rate that would result in a doubling in size in two years or less. According to the FHLBB testimony, the alarming aspect of this situation was that rapid growth could come about entirely from the aggressive solicitation and deployment of funds without managerial expertise or a plan for producing any sound and sustained earnings.

It is abundantly clear that the Federal Savings and Loan Insurance Corporation took on the risk of the imprudent growth engaged in by a segment of the industry. In 1982, approximately 80% of the FSLIC caseload was attributable to profit margin or spread problems, a legacy of historically high interest rates, and only 20% to asset quality problems. By 1984, that ratio had more than completely reversed itself.

Unfortunately, virtue, or running a sound operation, has not been rewarded by the FSLIC. In 1985, in order to bolster its reserves, the Insurance Corporation levied a special premium assessment of 1/8 of 1% of savings on all thrifts under its aegis, regardless of an institution's risk profile. This surcharge is patently unfair and burdensome. The healthy segment of the industry should not be called upon to bail out sick companies or the FSLIC.

There are further inequities which have been visited upon the entire savings and loan industry and become apparent by a comparison with the banking industry and the FDIC. In 1985, savings and loan associations, on insured deposits of approximately $841 *billion*, paid an estimated insurance assessment of .21% or $1.75 billion, while banks with insured domestic deposits of $1.79 *trillion* contributed an estimated $1.5 billion or only .08% to the FDIC. The cost for banks was proportionately far less despite evidence that the FDIC fund trend may be as bad as, if not worse than, the FSLIC's, and that potential losses of banks may be significantly larger than those of savings and loans.

The problems of both insurance funds will not be solved by ignoring them, applying Band-Aids intermittently, or jawboning. Rather, the fundamental structural, legal, regulatory, and supervisory inadequacies that are the root cause need to be dealt with. Congress must face up to its responsibility for the financial industry's distress and come forward with the requisite assistance. The situation cries out for recognition that new solutions are needed, and that these remedies can, in no way, burden institutions that operate in a safe, sound, and profitable manner.

Fast, efficient, friendly service is a Company hallmark. Here, a Customer Service Representative helps with a transaction.

Seven Deadly Sins

From William Blake's 'Dante's Inferno' by permission of the National Gallery of Art, Washington, D.C., Rosenwald Collection

How can a significant segment of the savings and loan industry be in trouble, when the fundamentals of the business are sound, simple, and straightforward? When there are profits to be made from following a well-trodden path or from emulating the actions of successful operations? Part of the answer lies in the past, but surely the root cause for many companies is the commission of one or more of the Seven Deadly Savings and Loan Sins.

Pride

Ignoring the lessons of the past

The early 1980's were very trying years for the savings and loan industry, brought about by an archaic legislative and regulatory structure, together with a hostile environment in the form of historically high interest rates. Long-term assets, the majority of which were fixed-rate loans, were mismatched against short-term, rate-sensitive liabilities. As a result, most companies lost money and experienced a substantial diminution of their net worth. Many were damaged beyond repair.

In the intervening years, there has been an opportunity for the survivors to prepare for the next interest rate cycle which will inevitably come. New legislation and regulations furnished the industry with the necessary tools, and a benign operating environment provided the climate to use them. Yet there are those who are stiff-necked. Who will not change their ways. Who continue to make long-term, fixed-rate loans funded by short-term liabilities.

> "Those who cannot remember history are condemned to repeat it."
>
> George Santayana, *The Life of Reason: Reason and Common Sense*

Avarice

Acquiring high-yielding, risky assets

For the past several years, regulators have been hit with a plague of institutions that are in trouble because of injudicious lending practices. Motivated by greed, these companies made speculative loans, often on properties that they were not competent to evaluate and in parts of the country with which they were not familiar.

Lust

Overreaching via mergers and acquisitions

Mergers and acquisitions (M&A in Wall Street parlance) are not in and of themselves sinful. But when damaged savings and loans are allowed to expand their ambit of operation, when companies stretch their resources too thin, when managements bite off more than they can digest, then the yen to grow through M&A can ultimately undermine the viability of an institution.

Gluttony

Neglecting fiduciary relationships

Growth for growth's sake, for the purpose of instant gratification and the accumulation of high fees without regard to long-term consequences, has been widespread. While beating their breasts like King Kong, managements brag about large inflows of rate-sensitive liabilities used to support unusually high levels of asset accumulation. These geometric increases in both savings and loans, however, have worked to the detriment of the Federal Savings and Loan Insurance Corporation (FSLIC) fund.

Envy

Coveting another's business

Led on by thinking that the "grass is greener on the other side of the fence" and the desire to reap big gains through diversification, many associations have become involved in running businesses about which they know very little. The latest fad, the gossamer appeal of being a department store of finance, and even the ability to use insured deposits to finance these ventures have been some of the driving forces behind this sin.

Sloth

Operating in a sloppy fashion

Except for a few periods of stress, savings and loan associations have been relatively easy to manage as long as major sins are not committed. Thus, it is not surprising that there has not been a premium placed on a tight operating style. High general and administrative expenses are the norm. Loan quality has deteriorated. Yet expense control and the absence of loan problems are the first line of defense against adverse circumstances, such as a change in the competitive or economic environment. This same sloppy thinking may also be the reason why strategic forward planning, which is so vital to a buttoned-down operation, is often neglected.

Wrath

Venting one's anger

Given today's troubled savings and loan operating environment, speaking out vociferously is more of a virtue than a vice. In discussing the current state of the industry, it is difficult to be restrained when profitable institutions, such as Golden West, are paying for the sins of others in the form of an extra premium to the FSLIC.

Perhaps the transgression here takes place when managements do not speak out loudly enough against the unsound practices that still abound; that the Administration, Congress, and regulators are not chastised for their failure to act in a more intelligent and courageous manner in formulating prudent guidelines for operating financial institutions; that government-sponsored agencies such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are permitted to grow exponentially in a manner incompatible with their charters and sound public policy. Perhaps it is myopia or a preoccupation with near-term results that prevents managements from taking a more global interest in matters which are so momentous. It is time for the industry to direct its anger and wrath as a positive force which will help to repair some of the damage that has been done, at the same time protecting the future health of the business and, thereby, ultimately, serving the best interests of the public.

APPENDIX 4

COMPARISON OF FEDERAL HOME LOAN BANKS TO FEDERAL RESERVE BANKS

Comparison Category	Federal Home Loan Bank (data as of 12/31/88)	Federal Reserve Bank (data as of 12/31/87)
1. Purpose	Promote economical home finance	Manage money supply Lender of last resort Correspondent services
2. Total assets	$175 billion	$276 billion
3. Total capital	$15.5 billion	$4.8 billion
4. Identity of shareholders	Savings and loans Savings banks	Banks
5. Amount of capital shareholder must purchase	Shareholder must purchase FHLB stock equal to approximately .8% of a shareholder's assets (FHLB shareholder capital investment requirement is four times the Federal Reserve shareholder capital investment requirement)	Shareholder must purchase Federal Reserve stock equal to approximately .18% of shareholder assets
6. Income paid to shareholders	$1.23 billion	$117.5 million
7. Income paid to shareholders as a percentage of total shareholder income (for year end 1988)	1988 FHLBank income paid to thrifts equaled 25% of GAAP-solvent thrifts' 1988 income	Approximately .5% of banks 1988 income came from Federal Reserve Bank dividends
8. Source of monies lent to shareholders	Borrow in capital markets	Print money
9. Outstanding borrowings in national and international capital markets	$136 billion	-0-
10. Loans to shareholders	$153 billion	$3.8 billion
11. Number of banks	12	12

The CHAIRMAN. Thank you, Mr. Sandler and Mrs. Sandler.

Mr. Fleischer, could we hear from you now?

STATEMENT OF ERNEST M. FLEISCHER, CHAIRMAN, FRANKLIN SAVINGS ASSOCIATION, OTTAWA, KS

Mr. FLEISCHER. Mr. Chairman, I am delighted to have an opportunity to testify before you today.

I believe that the changes proposed by the administration will not be sufficient to prevent the current situation from recurring. Accordingly, unless Congress is prepared to face economic reality at this time, it must be prepared to face the same problem which we are now facing again.

Currently, the American taxpayer is underwriting a Federal deposit insurance program that provides deposit insurance to institutions that are less than investment grade—in effect, junk credits.

I believe that the level of risk in our financial system is increasing, in large part because the current regulatory structure does not provide economic incentives for institutions to control their overall level of risk.

In the administration's proposal, the only economic incentive for financial institutions to limit risk is the increase in the capital requirements, which in my view provide only a minimum constraint.

I am convinced that if we cannot bring about a reduction in the deposit insurance premiums for both banks and thrifts, these industries run the risk of becoming the dinosaurs of the late 20th century.

Noninsured depository institutions such as mutual funds already appear to have a competitive edge in the delivery of some basic banking-like services. I believe that if we can implement a regulatory structure that ensures that the risks assumed by our insured depository institutions do not exceed those of an investment grade credit, default rates and deposit insurance premiums for both the banking and thrift industries will fall dramatically.

In response to Senator Wirth's request, I believe that the relevant issue should not be State powers versus Federal powers, but the care with which any power is exercised.

My proposal is very simple. Regulators should refuse to insure less than investment grade risks. This proposal would be implemented in two steps. First, I would suggest the formation of a new class of depository institutions, a class of basic banks. The basic banks would be able to perform a wide range of basic banking services, but they would not function as portfolio managers.

I believe that the major risks incurred by banking institutions involve portfolio management risks and that a large fraction of the managers of depository institutions do not currently have either the expertise or the systems to manage their portfolio risks effectively.

They are, however, very capable of accepting government guaranteed deposits, investing these deposits in maturity matching investment grade securities, performing low-risk transaction services, and originating and servicing local loans.

Basic banks would not hold loans in portfolio. They would be required to sell any loans that they originate within 90 days.

All other government-insured depository institutions would be quite similar to the multipurpose institutions that we know today. They would perform all of the activities of basic banks and, in addition, they would be permitted to act as portfolio managers. That is, hold in portfolio assets such as loans and securitized assets, but only if they are able to obtain an investment grade rating from at least one of the nationally recognized rating agencies.

The effective implementation of this proposal would accomplish the following: It would put a cap at the investment grade on the level of riskiness assumed by our depository institutions. Consequently, the risk exposure of the Federal deposit insurance funds would be dramatically reduced, which would in turn reduce the level of the premiums required to support these funds. It would set in motion a process for enlisting the private sector to contribute effectively to the oversight process by requiring rating agency involvement. At a minimum, this would provide an independent check on the Federal regulatory process.

The need to obtain an investment grade rating would motivate depository institutions to do a better job of measuring, monitoring, understanding and controlling their risks. It also may shift the focus of managers and regulators away from examining the risks of specific types of investments and business activities toward consideration of the risk-return tradeoff for an institution's total portfolio.

Finally, the explicit creation of a basic bank addresses the need to provide basic banking services at the community level, even in communities that are too small to support the development of the human capital and information systems that would be necessary to provide a quality portfolio management function.

In addition to this change in structure, I believe that we must put in place systems that will ensure that management and regulators have what they need to do their jobs. It is essential that we bring about a substantial upgrade in the level of understanding of risk management concepts and practices among both managers and examiners.

I have long advocated the development of a qualifying examination that all examiners, managers, and members of the boards of directors would be required to pass. Safeguarding America's deposits is the only profession of which I am aware that can be practiced without education, experience or a qualifying exam. Unfortunately, the results are obvious.

We must also facilitate a widespread distribution of the analytical tools needed to implement standard risk management transactions. One of the problems here is that in many areas there is no accepted standard of analysis. In the past, regulators have held back, waiting for such standards to emerge. Regulators should take a leadership role in developing and disseminating such standards, not just with respect to analytics but data standards as well.

As an example, during the period of deregulation, the asset most favored by the thrift industry has been adjustable rate mortgages. These mortgages carry with them a 100 basis point cap or 200 basis point cap per year and, without fail, a lifetime cap often at 500 basis points above an initial teaser rate. Each of these caps on interest rates is an option. It is the sale of an option by a government insured institution without requiring concurrently that that institution repurchase from the market that option.

These loans are very safe loans. They are loans which are necessary for the American consumer. But they are safe for our industry only if they are skillfully managed. If they are not skillfully managed, they can result in losses far exceeding the losses attributable to junk bonds.

During the past year, the market value of adjustable rate mortgages based upon the 11th District or California District cost of funds, has decreased by 5 percent, from a price of approximately $102.5 to a price of approximately $97.5.

For an institution which had those loans as its sole assets and capitalized at 5 percent last year, without appropriate risk management, would today have a zero capital base.

It is time to undertake a complete review of existing regulatory reports and the accounting conventions and the GAAP accounting statements that fail to report economic reality. The aim should be to provide managers and examiners with reports on the real economic conditions of the institution and of the industry. For too long, we have relied, to our detriment, on traditional accounting conventions.

Congress was misled in 1981 by conventional accounting statements. Our industry at that time had total assets of approximately $650 billion which had been invested pursuant to regulatory requirements in fixed-rate, fixed-term obligations, which at that time had an average interest rate between 8 and 9 percent.

The economic reality of our industry at that time was a loss in place of $250 billion, far in excess of the $100 billion about which we are concerned today. There was no publicity about that $250 billion loss because under historical accounting that loss was not reflected in any reports received by the regulators or received by Congress.

Regulators need to require that each institution must do a careful review of the profitability of all aspects of its business and prepare a business plan that lays out how it intends to ensure the institution's profitability in the future.

In addition, we need to develop a means of monitoring each institution's risk-adjusted profitability and its performance relative to the plan. Institutions that cannot implement their business strategies profitably should be required to terminate such activities.

Congress must also require that the Chairman of the Federal Deposit Insurance Corporation report semiannually to Congress about the state of the insurance fund. That report should include when losses will occur to the insurance fund by a change in the general level of interest rates, by a shift in the yield curve with respect to interest rates, by a change in the prepayment on home loans, by a change in defaults on home loans, and by a change in the volatility of interest rates since that volatility has a significant impact on the options which home lenders traditionally sell to the public.

Finally, with respect to the pending bill, there needs to be a mechanism that will allow for the immediate transfer of the deposit base to other institutions without waiting until all of the assets are sold. To delay that transfer will increase dramatically the cost of the unwinding of the bad institutions.

There continues to be a great need in the United States for the services which the thrift industry provides. Homeownership as we know it today would not have existed nor will it be able to be continued unless we have financial institutions that are prepared and able to provide the home lending service that historically has been provided. That service, however, must be provided in the future on the basis of economic reality and with proper risk management.

Many parts of that service today are being provided by nonmembers of the thrift industry. I do not see any need for a separate thrift industry. I do see a great need for the continuation of the services provided by the thrift industry.

If Congress decides that it is appropriate to subsidize housing, there are far more direct and effective ways to effect that subsidization than continuing to subsidize an industry as such. Direct subsidy is far more appropriate in ensuring the housing needs of the public are appropriately met.

I share all of the comments that Mr. Sandler made with respect to the fairness of the administration's proposed funding. I concur with him that it will be most difficult, if not impossible, for a thrift to raise capital if the administration's proposal is passed as it is.

I think we have seen already evidence of what responsible thrift managers are doing. They are taking steps to reduce their total deposits to come into compliance because they are confident that they cannot raise the requisite capital.

Our industry began the era of deregulation in 1981 with approximately a $250 billion loss in place. Industry members generally chose two speculations to make up that loss. Those who stuck to their knitting decided to continue business as usual with respect to home lending. The speculation which they made was the speculation that interest rates would decline. Any speculator can make a great deal of money in any market taking that speculation.

If interest rates in fact had not declined, those industry members today would be the ones about which we would be most concerned.

Other industry members instead sought a way in which to make up the large loss in place and correctly recognized that they could only make up that large loss by taking a speculation. The speculation which they chose involved real estate investments. Real estate had made money during the inflationary era of the 1970's. It worked during the 1970's. It didn't work during the 1980's.

However, if we had had inflation during the 1980's equal to or greater than that which we had during the 1970's, the real estate investors within our industry would have been today's survivors and we would be inquiring of those who stuck to their knitting about why they refused to take appropriate action in the early 1980's when they clearly saw or should have seen the handwriting on the walls.

Both types of speculation have to be terminated in the future by making certain that all industry members are properly capitalized and are operating prudent business plans. Otherwise, we create a federally insured casino where the taxpayers are the only ones who are certain to lose.

Thank you very kindly, Mr. Chairman.

[The complete prepared statement of Ernest M. Fleischer follows:]

Testimony of Ernest M. Fleischer, Chairman
Franklin Savings Association
Ottawa, Kansas
Before the Senate Banking Committee
Friday, March 17, 1989

Mr. Chairman, Members of the Committee, I am delighted to have an opportunity to testify before you today. I have been asked to comment on three topics:

- How to prevent the current situation from recurring.
- The need for, and viability of, a separately regulated thrift industry devoted primarily to housing finance
- How the cost of dealing with the current problem should be financed and the effect of the Administration's financing proposal on interested parties.

A. How to Prevent the Current Situation from Recurring

Let me first provide a summary of my views on how we should go about preventing the current situation from recurring. I have included with my testimony a short paper that elaborates on some of the points that I shall make here.

To begin with, the Administration proposal, in my view, represents a mere "tightening up" of the current system. It advocates higher capital requirements and a variety of organizational changes that, in effect, substitute an independent regulatory process for a self-regulatory process, the presumption being that independence is more likely to guarantee quality regulation.

I believe that these proposed changes will not be sufficient.

Currently, the American public is underwriting a federal deposit insurance program that provides deposit insurance to institutions that are, in effect, "junk" credits, and I see little hope that this will change.

I believe that the level of risk in our financial system is increasing, in large part because the current regulatory structure does not provide economic incentives for institutions to control their overall level of risk. In the Administration's proposal, the only economic incentive for financial institutions to limit risk is the increase in the capital requirements, which in my view, provide only a minimum constraint.

The major responsibility for limiting the level of risk assumed by institutions, and hence, the major responsibility for protecting the insurance funds, continues to fall on the regulators. I believe that it is unlikely that the regulators will be able to incur the expense that would be required to develop the skills and the systems necessary to analyze, monitor, and control the complex risks that are currently being assumed.

I am convinced that if we cannot bring about a reduction in the deposit insurance premiums -- for both banks and thrifts -- these industries run the risk of becoming the dinosaurs of the late twentieth century. Non-insured "depository institutions" such as mutual funds already appear to have a competitive edge in the delivery of some basic banking-like services. We cannot afford to let deposit insurance premiums drive any larger wedge between our costs and theirs.

On the other hand, I believe that if we can implement a regulatory structure that ensures that the risks assumed by our insured depository institutions do not exceed those of an investment-grade credit, default rates and deposit insurance premiums for both the banking and thrift industries will fall dramatically.

I. My proposal is very simple: Regulators should refuse to insure less than investment-grade risks.

This proposal would be implemented in two steps:

1. We would mandate the formation of a new class of depository institutions, a class of "Basic Banks" Basic Banks would be able to perform a wide range of basic banking services, but they would not function as portfolio managers.

I believe that the major risks incurred by banking institutions are portfolio management risks, and that a large fraction of the managers of small depository institutions do not have either the expertise or the systems to manage their portfolio risk effectively.

They are, however, perfectly capable of accepting government-guaranteed deposits, investing these deposits in maturity-matching investment-grade securities, performing low-risk transactions services, and originating and servicing loans. Note that Basic Banks would not hold loans in portfolio; they would be required to sell any loans that they originate within 90 days.

2. All other government-insured depository institutions would be quite similar to the multipurpose institutions that we know today: they would perform all of the activities of Basic Banks, and in addition, they would be permitted to act as portfolio managers (i.e. hold in portfolio assets such as loans and securitized assets) -- but only if they are able to obtain an investment grade rating from a least one of a number of "certified" rating agencies.

In other words, institutions today would be given two choices:

> If, in addition to providing deposit-gathering, transactions services, and loan origination and servicing, a bank or thrift wishes to function as a portfolio manager, it would be required to limit its overall risk to what would qualify for an investment-grade rating.
>
> If an institution could not qualify for an investment-grade rating, it would be required to either "exit the industry", or become a Basic Bank.

II. Effective implementation of this proposal would accomplish the following:

1. It would put a cap on the level of riskiness assumed by our depository financial institutions. Consequently, the risk exposure of the federal deposit insurance funds would be dramatically reduced, which would, in turn, reduce the level of the premiums required to support these funds.

2. It would set in motion a process for enlisting the private sector to contribute effectively to the oversight process. At a minimum, this would provide an independent check on the federal regulatory process. The increased competition also may result in an increase in the overall quality of the oversight process, eg. by increasing the demand for quality analysts who, in turn, would be motivated o improve the analytical methods and systems used to evaluate financial institutions.

3. The need to obtain an investment grade rating would motivate depository institutions to do a better job of measuring, monitoring, understanding, and controlling their risk. It also may shift the focus of managers and regulators away from examining the risks of specific types of investments and business acitivities toward consideration of the risk/return trade-off for an institution's total portfolio.

4. The explicit creation of a Basic Bank addresses the need to provide basic banking services at the community level, even in communities that are too small to support the development of the human capital and information systems that would be necessary to provide a quality portfolio management function.

III. In addition to this change in structure, I believe that we must put in place systems that will ensure that management and regulators have what they need to do their jobs.

1. It is essential that we bring about a substantial upgrade in the level of understanding of risk-management concepts and practices among both managers and examiners. I have long advocated the development of a qualifying examination that all examiners, managers, and members of boards of directors would be required to pass. Safeguarding Americas deposits is the only profession of which I am aware that can be practiced without education, experience, or a qualifying exam. Unfortunately the results are obvious

2. We must also facilitate a widespread distribution of the analytical tools needed to implement standard risk management transactions. One of the problems here is that in many areas there is no accepted standard of analysis. In the past, regulators have held back, waiting for such standards to "emerge". I would argue that the regulators could take a leadership role in developing and dessiminating such standards -- not just with respect to analytics, but data standards as well.

3. This leads right into my next point. It is time to undertake a complete review of existing regulatory reports and the accounting conventions and the GAAP accounting statements that fail to report economic reality. The aim should be to provide managers and examiners with reports on the real economic condition of the institution. How else can one effectively manage a business? For too long, we have relied on traditional accounting conventions.

4. Finally, regulators need to require that each institution do a careful review of the profitability of all aspects of its business and prepare a business plan that lays out how it intends to ensure the institution's profitability in the future. In addition we need to develop a means of monitoring each institution's risk-adjusted profitability and its performance relative to plan. Institutions that cannot implement their business strategies profitably should be required to terminate activities.

B. The need for and viability of a separately regulated thrift industry devoted primarily to housing finance.

I personally can see no need for a separately regulated thrift industry. In particular, I can think of no activities that have been "reserved" for savings associations that are not already being done by other financial institutions.

Accordingly, thrifts should both be permitted and required to conduct their activities in the same manner and under the same terms and conditions as other regulated providers who use insured deposits.

If housing industry subsidy is deemed desireable, that subsidy can be provided more effectively in ways other than by or through a separate thrift industry. If, for example, we view access to FHLBB to be the main advantage to being a thrift, there is no reason why this advantage should not be extended to all institutions making mortgage loans.

Does this mean that the thrift industry should be abolished? Not necessarily, although I would argue that any substantial differences between banks and thrifts in licensing, regulation, and tax advantages should be eliminated as quickly as possible and a new federal insurance fund should be created that would insure deposits of investment-grade credits.

Would the thrift industry as we know it today be viable in such an environment? Certainly a substantial portion of the industry would be viable, and the remaining institutions should probably have been closed down long ago. The issue of viability depends on the particular advantages of individual institutions. I would argue that every profitable institution has some particular advantage in the market, be it a captured deposit base, superior loan underwriting, low cost servicing capability, whatever. These advantages will exist whether the institution is chartered as an thrift or as a bank, and if they do not exist, the charter is irrelevant.

C. How the cost of dealing with the current crises should be financed and the effect of the Administration's financing proposal on interested parties

The taxpayer should pay for the losses sustained since any other allocation of losses is both unfair and counterproductive

Pre 1981 policy was designed to subsidize the homeowner and the housing industry at the expense of savers, the thrift industry and the taxpayers by controlling deposit rates and by providing deposit insurance at lower than market rates

- Savers lost since the rates received by them were less than market rates would have been if rate controls had not existed

- The thrift industry lost because it was required by governmental policy
  - (i) to borrow short and lend short if interest rates declined since homeowners had the right to prepay their loan or
  - (ii) borrow short and lend long if interest rates increased since homeowners have the right to make contractual payments over thirty years.

  Thus the thrift industry lost because it was required to write an uncovered option for the benefit of homeowners and the housing industry

- Taxpayers lost, since the cumulative fees to the insurance fund together with the earnings thereon were inadequate to reimburse the losses sustained by the thrift industry from the uncovered option being "in the money" when interest rates increased in the late 1970s and early 1980s.

Post 1981 policy sought to reimburse the thrift industry for its losses by granting to it powers to engage in transactions that, in the absence of financial capital at risk and human capital with the requisite skills, was certain to result in the additional losses that are now evident.

Even with financial capital at risk and human capital with the requisite skills the industry would not have recovered its pre 1981 losses using the powers granted in 1981, because the pre 1981 losses resulted from a speculation, ie, writing an uncovered option, which competent managers of financial capital would find imprudent in a deregulated industry

Accordingly the current thrift industry losses result from two public policy determinations:
  i) to require the thrift industry to write an uncovered option
  ii) to compensate the thrift industry for that option by granting to it powers that some industry members abused

Imposing any part of the burden of losses on the healthy part of the industry is
  i) unfair since that part of the industry did not cause nor benefit from the losses and
  ii) counterproductive since such costs must be borne by either capital or labor, both of which the industry needs to employ without market penalty to compete in a deregulated market

Unless a particular class of taxpayers benefit from or cause a public loss, that loss, such as the thrift industry loss, must and should be born by taxpayers generally.

Thank you again for inviting me to testify here today. I would be pleased to answer any questions.

HOW DO WE PREVENT A REPEAT OF THE CURRENT SAVINGS AND LOAN CRISIS?

Comments of Ernest M. Fleischer, Chairman
Franklin Savings Association in Ottawa, Kansas

The problems of the savings and loan industry have captured the headlines for many weeks now. The Congress, the Administration, the regulators, as well as representatives from both the thrift and commercial banking industries have all debated the questions: "What happened?," "Why?," "How big is the problem?," and inevitably "Who is responsible?," and "How should it be paid for?" I fear that the political process may expend so much energy addressing these questions that there will be no time and resources left to debate and resolve the more fundamental issue of: "How do we prevent the current situation from recurring?"

Most of the discussion to date has centered around the need for higher capital ratios, better oversight, and more effective enforcement of the regulations (including a greater willingness to close down unprofitable institutions). The Administration's proposal advocates raising the capital requirements for thrifts to equal those required of commercial banks. It also contains a variety of measures that, in effect, substitute an independent regulatory process for a self-regulatory process, the presumption being that this is more likely to guarantee quality regulation.

In my opinion, the Administration is proposing only that we "tighten up" the current system. The implied assumption is that the current system, if properly implemented, will work and will work at a cost that society is willing and able to pay. I seriously question the validity of this assumption.

- I believe that the level of risk in our financial system is increasing, in large part because the current regulatory structure does not provide economic incentives for institutions to control their overall level of risk. In the Administration's proposal, the only economic incentive for financial institutions to limit risk is the increase in the capital requirements, which, in my view, provide only a minimum constraint.

- Currently, the American public is underwriting a federal deposit insurance program that provides deposit insurance to institutions that are, in effect, "junk" credits, and I see little hope that this will change.

- The Administration's proposed regulatory changes do not address the role of deposit insurance in our financial system, and leave the deposit insurance funds exposed to the full range of risks assumed by insured institutions.

- The major responsibility for limiting the level of risk assumed by institutions, and hence, the major responsibility for protecting the insurance funds, continues to fall on the regulators who, I believe, will be unable to incur the expense that would be required to develop the skills and the systems necessary to analyze, monitor, and control the complex risks that are currently being assumed.

I am convinced that if we cannot bring about a reduction in the deposit insurance premiums -- for both banks and thrifts -- these industries run the risk of becoming the dinosaurs of the late twentieth century. Non-insured "depository" institutions such as mutual funds already appear to have a competitive edge in the delivery of some basic banking-like services. We cannot afford to let deposit insurance premiums drive any larger wedge between our costs and theirs.

On the other hand, I believe that if we can implement a regulatory structure that ensures that the risks assumed by our insured depository institutions do not exceed those of an investment-grade credit, default rates and deposit insurance premiums for both the banking and thrift industries will fall dramatically.

The challenge is to design:

- a system that insulates the deposit insurance fund from the crises in risk management that inevitably will occur in the future as financial markets continue to develop and become more integrated.
- a system that motivates institutions to focus on analyzing, understanding, managing, and ultimately reducing the risk in their own portfolios.
- a system that increases the quality of the oversight process without increasing the costs beyond what society is willing to pay.
- a system that allocates more of the costs of oversight back onto the institutions bearing the risk, and minimizes the costs of oversight allocated to the taxpayers.

A Simple Proposal: Regulators Should Refuse to Insure Less than Investment-Grade Credits

My basic suggestion is very straightforward: that regulators simply refuse to insure less than investment-grade risks. There are two steps to implementing my proposal:

First, I propose that we mandate the formation of a new class of depository institutions, a class of "basic banks." Basic Banks would have limited scope. They would be able to accept government-guaranteed deposits but they would be required to invest those deposits into maturity-matching, investment-grade securities. Basic Banks also would perform low-risk transactions services, and originate and service loans, but they would not be permitted to hold these loans indefinitely in portfolio -- instead, they would be required to sell such loans within 90 days of origination.

The key point is that although a Basic Bank would be able to perform a wide range of basic banking services, it would not function as a portfolio manager. I believe that the major risks incurred by banking institutions are portfolio management risks, and that a large fraction of the managers of small depository institutions do not have either the expertise or the systems to manage effectively their portfolio risk. Most such organizations would, however, be perfectly capable of operating within the constraints of the Basic Bank, as I have described them. Smaller communities would receive basic banking services at virtually no risk to the federal deposit insurance funds. Indeed, I would argue that such institutions would be implicitely "investment grade."

The notion of a bank that is essentially a deposit gatherer has been put forward on a number of occasions. To the extent that there is anything new here, it is the proposal that such institutions be able to originate and service loans, but not hold them in portfolio. Traditionally, financial institutions -- especially smaller institutions in smaller communities -- have tended to give preference to local borrowers, believing that the risk of default could be more carefully judged and monitored. Unfortunately however, such a strategy also increases the institution's exposure to the risk that the regional economy may weaken. Such high exposure, in turn, reduces the institution's ability to be a resource to the local community just when the community needs it most. I believe that in many cases, the community is actually better off when the local institution does not hold the loans, so long as it has access to a well-developed national secondary market. An appropriate role of regulators might be to promote the development of such markets.

Second, I propose that all other government-insured depository institutions would be quite similar to the multipurpose institutions that we know today: they would accept government-guaranteed deposits, and they would perform a variety of transactions services. They also would originate and service loans. In contrast to Basic Banks, these institutions would be permitted to act as portfolio managers -- but only if they are able to obtain an investment grade rating from at least one of a number of "certified" rating agencies.

There are several advantages to such a structure:

- First, if the proposal can be successfully implemented, all institutions would be at minimum, investment grade credits. Consequently, the risk exposure of the federal deposit insurance funds would be dramatically reduced, which would, in turn, reduce the level of the premiums required to support these funds.
- Second, by requiring non-basic banks to maintain investment-grade ratings, we will set in motion a process for enlisting the private sector to contribute effectively to the oversight process. At a minimum, this will provide an independent check on the federal regulatory process. In addition, the added competition may result in an increase in the overall quality of the oversight process, eg. by increasing the demand for quality analysts who, in turn, would be motivated to improve the analytical methods and systems used to evaluate financial institutions.
- Third, the need to obtain an investment grade rating will motivate depository institutions to do a better job of measuring, monitoring, understanding, and controlling their risk. It also may have the result of shifting the focus of managers and regulators away from examining the risks of specific types of investments and business activities toward consideration of the risk/return trade-off for an institution's total portfolio.
- Fourth, the explicit creation of a Basic Bank that is targeted to deposit gathering, transactions services, and loan origination (for immediate sale to portfolio managers) addresses the need to provide basic banking services at the community level, even in communities that are too small to support the development of the human capital and information systems that would be necessary to provide a quality portfolio management function.

The Need to Obtain An Investment Grade Rating Would Enlist the Private Sector Into the Oversight Process

I would expect that the immediate impact of a requirement that those depository institutions choosing to be portfolio managers must maintain an investment grade rating would be to motivate an extensive public discussion of how financial institutions should be evaluated, what data is necessary, what form it should be delivered in, what changes should be made to the GAAP accounting standards, what changes might result in the standard auditing procedures, etc. I would suggest that an appropriate role for the regulators would be to encourage this debate, to solicit comments from the appropriate experts (FASB, finance academics, key analysts within the rating agencies, the securities firms, and the regulatory arena, as well as representatives from the industry) and to manage the process of redesigning regulatory and financial reports to meet the needs of both public and private sector analysts.

Indeed, a major role of federal regulatory agencies in such a system would be to monitor and oversee the private sector's response to the requirements a) that basic banks must sell any loans that they originate and b) that banks assuming a portfolio management role must obtain an investment grade rating. I believe that where possible, regulators should seek to increase the efficiency of the routine oversight process to the point where it can, in effect, be licensed to the private sector. Whenever this licensing approach seems unrealistic, the regulators' reaction should be to explore what changes might make licensing more realistic -- for example, improved reporting or better data or communications systems.

I am not suggesting that regulators would completely withdraw from the oversight activities, but I do believe that they need to become more creative in dealing with routine issues. By enlisting the private sector, and by focusing on improving the underlying systems of the regulatory process, regulators should be able to reduce the time and resources spent providing regular reviews of every insitution and increase their focus on those institutions were there are real problems.

Some people may argue that my proposal cannot work: that there are not enough rating agencies to do this job effectively, that they are not appropriate for this role, that there will be a tendency for competition among the different rating agencies to promote laxity in oversight. In my opinion, the number of rating agencies would increase to meet the demand. As to competition, I believe that on balance its effect would be positive, not negative. An appropriate role for our regulators in such a system would be to, in effect, license the rating agencies and to monitor carefully the rating processes used by each. If there is clear evidence that one rating agency is doing a less diligent job of evaluating its clients, it would be dropped from the "approved list".

Requiring institutions to obtain an investment grade rating is only one of a number of ways in which different aspects of the oversight process might be pushed out into the private sector. In my view, the role of regulators should be to encourage and to manage this process, because the long-term advantages to the industry and to the taxpayers are many. They promote competition in the oversight process that, in turn, may result in:

- faster response,
- more innovation in the analytical methods and systems used to evaluate financial institutions,
- a greater liklihood of the oversight process being able to attract the level of talent needed to do such complex analysis,
- less politically-influenced decision making (not just with respect to the financial health of different institutions, but also with respect to the evaluation process being used and the resources available to implement that process.)

Regulatory Constraints on Institutions Should Focus on Defining and Attaining An Acceptable Level of Risk, Not on Limiting the Types of Permissable Investments or Businesses

I believe that if depository institutions were required to obtain an investment grade rating in order to retain their federal deposit insurance, they would be far more motivated than they are currently to focus on understanding, measuring, and controlling the actual risk/return tradeoffs in their portfolios. Moreover, the focus of managers and regulators would be shifted away from examining the risks of specific types of investments and business activities toward consideration of the risk/return trade-off for an institution's total portfolio.

In my view, it is inappropriate for regulators, for example, to proscribe investment in a particular type of security. Individual investments should be evaluated on the basis of how they contribute to the risk-adjusted return and the overall level of risk of the institution. As long as an institution is both profitable and safe, it should not be restricted or encouraged to invest in a particular type of asset or in a particular line of business. Indeed, I would argue that as long as the institution can obtain an investment grade rating, no financial services-related activity should be prohibited.

I expect that regulatory barriers to competition among different providers of financial services will continue to erode, with the resulting financial structure reflecting the comparative advantages of individual institutions in providing the various types of financial services. I am not in favor of reversing this process. In this context, the regulatory and tax benefits that now motivate thrifts to invest in residential mortgages would be eliminated. Does that imply that these institutions would not invest in mortgage-related assets? Not at all. I would argue that as long as an institution was willing and able to limit both the credit and interest-rate risk within acceptable boundaries (without the hedging and diversification costs eating up all the profit), there is every reason to expect that part of its portfolio would be in mortgages and/or mortgage securities.

I do believe, however, that my proposed structure will be more effective at motivating holders of mortgage assets to understand and manage better the risks involved. For example, in order to obtain an investment grade rating, an institution chosing to invest in residential mortgages and fund them with short term deposits presumably would be required to incur the cost of hedging the interest rate risk. Similarly, if a government-insured institution chooses to orginate and hold whole loans (rather than purchasing agency-guaranteed mortgage-backed securities), it is likely to be required to follow prescribed underwriting standards and to diversity the geographical location of the loans.

If We Insist on Insuring "Junk" Credits, We Must Recognize the Extent to Which the Insurance Funds are Exposed and the Enormous Costs of Monitoring and Controlling that Risk

In my opinion, the main role of deposit insurance should be to ensure that there is a safe depository for personal savings. As long as an institution is, in effect, being insured by a federal deposit insurance fund, that institution's overriding responsibility must be to the safety of the fund. The responsibility of regulators in such an environment is to determine specifically what risk standards must be met, and develop a process that enforces those standards.

I would argue that the current policy of insuring non-investment grade credits is not necessary, and that it imposes significant costs on society:

- This is an inefficient way to subsidize economic growth: it provides such institutions with unwarranted special advantages that are not available to competing institutions that provide similar services.
- The current system is one in which it is extremely difficult for us to allow poorly managed, unprofitable financial institutions to fail.
- The current system ties us to an extensive regulatory structure that is tremendously expensive without being very effective in protecting the federal insurance funds from the growing level of risk in our financial system.

The problem with opting for a broader-based federal insurance program, coupled with an extensive regulatory system to control risk, is that it is not only difficult and costly to implement, but subject to some basic inefficiencies that may, in the end, overwhelm the potential benefits.

- The actual risks being assumed are complex and not easily evaluated.
- The format for data being reported by institutions often does not reflect current reality.
- There is great incentive on the part of regulators to reduce the costs of regulation by applying "rules-of-thumb" or "standard ratios" or other shortcuts instead of analyzing the specific risks inherent in an institution's business.
- There is almost always a lag in the regulator's ability to catch up with new developments in the financial markets.
- The examiners ability to implement the regulations is constrained by the government-mandated need to minimize the burden of regulation on those being regulated and the apparently permanent budget constraints on regulatory agencies.

The Specific Focus on Risk Management Requires More Skills, Better Information Systems and Better Analytical Tools

Financial regulation today places heavy emphasis on ensuring that the procedures followed by an institution minimize what I will call "operational risks" (fraud, mismanagement, poor accounting or computer systems, etc.) Although this is an essential aspect of any regulatory system, the current crisis has demonstrated that both managers and regulators must increase their focus on defining, measuring, and managing both the risk and the profitability of institutions.

Regardless of whether we adopt some or all of my proposals or work within the context of the Administration's proposal to increase the efficiency of our current regulatory system:

- Mangers must have the technical skills to engage in their chosen businesses;
- Mangers must have the appropriate information systems and analytical tools to measure and manage both risk and profitability;
- Managers be required to pursue a business strategy that has a reasonable likelihood of being both profitable and safe.

We currently are a long way from this ideal situation. In my opinion, it is essential that we:

- Bring about a substantial upgrade in the level of understanding of risk-management concepts and practices among both managers and examiners.
- Facilitate a widespread distribution of the analytical tools needed to implement standard risk management transactions.

- Undertake a complete review of the accounting conventions and regulatory reports with an aim to providing managers and examiners with reports on the real economic condition of the institution.
- Require each institution to do a careful review of the profitability of all aspects of its business and prepare a business plan that lays out how it intends to ensure its profitability in the future.

Upgrading the Level of Understanding of Risk-Management Concepts and Practices

Monitoring the risk-adjusted profitability of different investments assumes that both the regulators and the mangers understand the risks involved. In my view, any institution that intends to hold a portfolio of mortgage investments needs to understand and be able to evaluate the option characteristics of these instruments. If such institutions do not have the ability to evaluate their risk-adjusted returns; if such institutions do not know how to use the financial markets to hedge the options risk -- then those institutions, and through them the government insurance funds, are assuming substantial risk.

This is not just an issue for mortgage investors. In my view, managers should not be allowed to hold any assets whose risk characteristics are not completely familiar to them. It is essential that examiners also be knowledgeable, but this is no substitute for management expertise. Unless the institutions, themselves, are in a position to understand and manage the risks involved, it is highly unlikely that regulators will be able to collect the information necessary to be able to fulfill their oversight role.

Managers and Regulators Should be Required to Pass A Risk-Management Exam

The most efficient way for the regulators to force an upgrade in the understanding of risk management would be to commission the development of a risk-management examination by a team of highly regarded academics working closely with regulators and industry personnel. All regulatory examiners, as well as the senior managers and director of savings institutions should be required to pass this exam. I believe that if such a test were developed and administered by the regulators, the private sector would certainly rise to the occasion of developing the courses to provide the background necessary to pass the test. I believe that any managers and directors who are unable to become accredited in this manner should be required to resign.

Existing managers and directors may find this to be a draconian proposal, but in my view, it is essential. The current morass was not, as so many have argued, caused by deregulation, but by the inability of existing thrift management to understand and respond intelligently to the new risk they faced as a result of deregulation. We are naive to believe that we will ever be able to contain the exposure of a federal deposit insurance system without significantly upgrading the quality of management.

Facilitating the Widespread Distribution of the Necessary Analytical Tools

Intelligent and well-trained managers and examiners are not enough. These individuals must also be supported by appropriate information systems and analytical tools. This is another area in which Franklin has devoted substantial resources. It is my belief, however, that if the regulators were to define and require all institutions to have available whatever information systems and analytical tools were necessary to make informed management and investment decision, the private sector would be motivated to package software products that would make such tools widely available at a reasonable cost.

Developing Accounting Conventions and Regulatory Reports that Reflect the Real Economic Condition of our Institutions

One information system that is an integral part of every institution deserves special comment: the basic financial reporting system. It is impossible for managers to manage effectively when the real economics of their businesses are not being captured by currently accepted accounting conventions.

There are a number of issues here. In general, accounting conventions look to historical cash flows and GAAP accounting statements require a number of arbitrary adjustments that are not supported by economic activity.

It is important that regulators provide the industry with analytical, reporting, and data standards that will permit managers and examiners to focus on and manage to real economic results. In my view there needs to be a complete review of the current reporting requirements and accounting standards. I believe that all institutions should be required to estimate their current income as the present value of their expected cash flow spread. Again, if the regulators were to focus on developing the analytical, reporting and data standards, the private sector (data processing service bureaus etc.) would be motivated to make the necessary investment to enable individual institutions to adjust at a reasonable cost.

Requiring an Ongoing Review of Profitability and Regular Updating of Business Plan

It is essential that going forward managers be required to gain a thorough understanding of the determinants of profitability of the various aspects of their businesses and acquire the resources to monitor this profitability over time. Regulators should not only require each institution to prepare an annual business plan, but they also should develop a means of monitoring each institution's risk-adjusted profitability along with its performance relative to plan. Institutions that cannot implement their business strategies profitably should be required to terminate activities.

Summary

In my view, the Administration's proposed tightening alone cannot be relied upon to protect us from the next crisis. The current crisis originated in our inability to understand and manage the options risk in fixed-rate mortgage lending -- a risk that existed all along, but was "exposed" with the deregulation in deposit rates. That crisis happened in the thrift industry because thrifts were doing most of the fixed-rate mortgage lending. The next crises will happen wherever the next new, unfamiliar, or misunderstood risk is assumed. We must act now to minimize the impact on the federal deposit insurance funds and to motivate managers of financial institutions to implement procedures to measure, monitor, manage, and control their own risk.

Three kinds of changes to our regulatory system are called for:

First, we must insulate the federal deposit insurance programs from the major risks inherent in providing capital for economic growth. To this end, I propose that we require insured deposits to be invested either in investment-grade assets or a portfolio that is so rated.

Second, we must devise a system that motivates institutions to understand and take into consideration the real risks of their operation, and we must do so without dramatically increasing the cost to the government of regulatory oversight. To this end, I propose that we redefine the regulatory process in a way that, in effect, recruits private sector firms into the oversight business. In particular, I propose that regulatory agencies require all depository institutions that choose to act as portfolio managers to obtain and maintain an investment-grade rating from one of a number of designated rating agencies.

Third, we must ensure that managers have the technical skills to engage in their chosen businesses and are supported by the information systems and analytical tools needed to measure and manage both risk and profitability. We must also ensure that managers are pursuing a business strategy that has a reasonable likelihood of being both profitable and safe. To these ends, I propose

- a) that the regulators commission the development of a risk-management exam that all examiners, managers, and boards of directors would be required to pass,
- b) that the regulators commission a major review and redesign of both the standard accounting reports and the regulatory reports, with an aim to providing both regulators and managers with information that reflects economic reality,
- c) that the regulators commission a study of how the routine regulatory reporting process can be streamlined (through better computerization, better application of communications technology, etc.),
- d) that the regulators design a new regulatory report that defines the expected safety and profitability of an institution's business plan and provides a means of tracking an institution's performance against plan.

Finally, I should note that there is not, to my knowledge, any empirical evidence clearly indicating that the oversight function, as I have described it, could be more efficiently provided in the private sector than in the public sector. My proposals are based on my own experience in the industry, which has engendered a strong personal bias that there are too many inherent constraints on government bureaucracies to expect them to provide the sole effective oversight and risk control -- especially to such a vital and changing industry. Obviously, the ideas that I have expressed are not the only approach to these issues, and I would welcome a more active debate. I do believe that we can no longer afford to presume that "business as usual" will work, and I sincerely hope that members of the Congress, the Administration, and the industry are able to see far enough beyond the current crisis to give some consideration to longer-term proposals such as this one.

The CHAIRMAN. Thank you, Mr. Fleischer.

Before we go to Mr. Ranieri, let me just say that Senator Kassebaum has come in and of course I know she's very interested in the comments that you have made coming as you do from Kansas. Senator Bryan has also joined us. I'm wondering, Senator Kassebaum, did you want to make an initial comment now?

Senator KASSEBAUM. No, thank you, Mr. Chairman. I will wait until the discussion.

The CHAIRMAN. Very good. Senator Bryan.

Senator BRYAN. No opening statement, Mr. Chairman.

The CHAIRMAN. Mr. Ranieri, we would be pleased to hear from you now.

STATEMENT OF LEWIS S. RANIERI, PRINCIPAL, RANIERI WILSON AND CO., INC., NEW YORK, NY

Mr. RANIERI. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, given what's been said, I can't wait for the give and take so I'm going to depart from my prepared text here and try to give you a 2-minute summary and then encapsule the rest.

In general, I'm in favor of the administration's proposal because it does two things that were necessary and were in fact in my mind at the root of all the problems, and that is require real capital, so that when people play it's with their money instead of the Government's.

It also attempts to clean up the accounting issues so that both the regulators and the public at large know where an institution is in terms of its financial viability, and also attempts to stop institutions from obfuscating what's going on—now and in the future.

Where I have trouble with the administration's plan—it's not from finding myself in the thrift industry for the first time or believing that somebody should have mercy on thrifts or be kind to thrifts or take up a donation for thrifts—but from a very hardheaded business logic. Given the magnitude of the problem and the thrift industry's involvement, I can't imagine why anybody should think thrifts should be—somebody should be merciful to them or be kind to them or whatever. It's simply from the point of view that if you push too hard on the industry as it is now, you may in fact create more insolvencies, and therefore more losses than the amount of money you're trying to raise.

So there's a fine line to be walked between the amount of money you extract—and I have no particular reason not to say you should extract everything you can up until the point where it becomes self-defeating. And the reason it becomes self-defeating is something that seems to be eluding people. That is, thrifts, like all financial institutions—commercial banks, insurance companies—carry their assets at book, not at market. So capital has nothing to do with book.

As an example, you could have a thrift which has 2 percent or 3 percent real GAAP net worth, with no fictional accounting. That doesn't mean that if you try and liquidate it you will wind up with 2 percent because those assets are being carried at book and when you liquidate you liquidate at book. You don't liquidate at capital.

So if you went to liquidate them, you might find that book was a loss of $500 million.

So there's a balance between knocking people off the table, which has to be done in this case, and the costs to the Government. There is no reasonable circumstance which will save all the institutions in the industry. I think the issue that the Congress has to decide is how far it goes in terms of how many go off the table, and that point in my mind is very simply the point at which it's self-defeating, where you're actually costing the taxpayer more money than the amount of money you're trying to extract from the industry.

The second general reluctance I have is that I've been in housing all of my career and I have a very deep-seated bias about turning over to anybody other than the Congress the political ability to ration the amount of funds that flow into housing. And if through the guise of supervision the Treasury or anybody else can control the political decisions on the lending policies of the Home Loan Bank System and the thrift industry, they control housing. They can sit there and determine the flow of funds into housing and that is a prerogative that I've always felt belongs in the Congress and should stay in the Congress.

Those are my two general reluctances with the bill as it's currently proposed. I don't think they are incapable of being overcome, but I do think they're worth looking at.

Let me go back and try to encapsule my prepared comments.

The first one is in the context of the need for the thrift industry. As some of you are aware, I've spent much of my professional career helping to build essentially from scratch what is now a highly efficient secondary mortgage market, with the help of, in fact, this committee which helped us pass two bills.

The secondary mortgage market has increased the availability of mortgage money at reasonable interest rates by increasing the liquidity of mortgages in the hands of the thrift and successfully attracting new money for housing from institutional investors, such as insurance companies, pension funds, foreign investors, individuals. As one who has spent much of his professional life building and nurturing this market, I want to tell you that the secondary market was never intended to supplant the role of the thrifts as housing lenders and, indeed, it cannot do so in the near term without significant dislocation and cost to the housing finance system.

The continued need for the thrift industry hinges on the fact that the secondary mortgage market, despite its success, has not and will not eliminate the need for institutions or individuals to actually lend money. I'll cut out some of the other things I was going to say.

Any significant reduction of the ability of willingness of thrifts to hold residential mortgage loans and mortgage securities, or frankly in the sheer number of thrifts, would be cutting into the muscle of the mortgage lending market and would, in my judgment, severely impact the availability of mortgage money at reasonable interest rates.

Moreover, in my view, the thrift industry is viable as a specialized housing lender. Residential lending has not been overwhelmingly the cause of the current problems facing the insurance fund.

And residential lending is not merely a safe business, it is profitable. That is what attracted me to getting into the industry. If you look at the numbers and realize the thing that ultimately counts—forget how it gets there—is who originates the loan and, most importantly, who ultimately winds up with it in its portfolio.

The thrifts have maintained their position. It is in fact everybody else that's jockeyed around in terms of their role in housing. The position of the thrifts in housing has remained remarkably constant at between 40 and 50 percent, even when you take into consideration the enormous explosion of demand for the funds.

So until somebody tells me who or what it is that is supposed to pick up the slack—not in terms of who turns them into securities and who breaks them up into CMO's, but who ultimately lends the money long term, I don't see how you do away with the thrifts.

Let's get rid of a couple more pages here. Let me go to the specific changes I was referring to.

The deposit insurance premium rates should be, in my opinion, statutorily established by the Congress and not set by the insurance agencies. This is essential in my mind to assure those putting new capital into the thrift industry that the industry will be allowed, in fact, to earn money, and that substantial additional premiums cannot be imposed subsequently through administrative fiat. An open-ended premium, in my mind, will act as just a tremendous inhibitor to attracting capital into this industry.

Since you're not going to be able to generate a large amount of capital through earnings because of the assessments, which I understand, you certainly have to depend on it coming in from the outside. If you hang up a sign that says, "Well, gee, you may never be able to make money because it's constantly going to be garnisheed," you're not going to get that either.

So I really think that whatever the bill is, and I'm not suggesting the bill be light, it's knowable and definable and the only guy who can change the bill should be the Congress. The Treasury Department's proposed oversight over the newly constituted Federal Home Loan Bank System should constitute, in my opinion, as I suggested earlier, a supervisory role only and should not allow the congressional decisions regarding housing policy and lending policy to be supplanted.

The levies which the bill would impose on the capital of the Home Loan System in my mind should either be reduced or restructured. Although a substantial initial levy in a fixed amount is again necessary, I think that when you look at $2.7 billion contemplated by the bill and then $300 million a year forever for 30 years—when you think about that and again look at the numbers—I think there's probably a set of this in Mr. Sandler's presentation—you have to remember that the industry will shrink and, in my opinion, the Home Loan Bank System will shrink. So, as an example, $300 million, which is about 20 percent of the current earnings, is going to be an everincreasing amount of the earnings going forward. I just think it's unrealistic to believe that the industry and the Home Loan Bank System is not going to shrink.

So eventually it becomes so burdensome that it topples the game, or that the Home Loan Bank can't borrow at the rate that it's currently borrowing, and therefore that adds to the pressure.

I think at the very least the most logical thing to do is—I may not be right but you can't assure me that I'm wrong—is that that should be turned into a percentage. So what you're really saying is 20 percent of their income, and then levy 20 percent of their income, because I'll bet you dollars to doughnuts that $300 million will be a lot more than 20 percent of their income in a couple of years.

I strongly support the bill's concept of requiring adequate capital for thrift operations. And the provisions in fact requiring the capital are, in my mind, the most important. And I strongly support the 6 percent risk-based capital proposal. I guess my trepidation is whether—if you try to do it by 1991—you're in fact not crossing that line between what you've got to do and creating more losses than you are creating money that you're trying to get. I think that probably something like 1993 is more reasonable, but again, that's the decision that this committee and the Congress finds itself in, which is, "Where is that fine line?" It's not, "Don't pay," but where do I put the line?

That's also an issue with goodwill. I intellectually agree that goodwill isn't capital. The fact is, there's an immense amount of good will in the industry and if you try to do away with it altogether overnight, the cost is catastrophic. And the point of that again becomes—we should get rid of it, but how do we get rid of it—amortize it over what period? Again, I think 10 seems to me, if you look through the numbers, to be too short. I would suggest something closer to 15 than the 10, but again that's the issue—where is the crossover point?

Here there is a really terrible fairness point. The good will in the industry is largely supervisory good will, good will people got from doing business with their regulators. So there's this sort of terrible point where the guys with the good will are the guys that the system relied on to help, and so you wind up shooting the guys that helped, and the guys that didn't do business with the system didn't get hurt. That's really a moral dilemma, but I intellectually understand the problem.

Speaking to the present qualified thrift lender requirement, I guess I think the 60 percent is as good a number as any, although I don't have a problem with the idea of 70 percent as a QTL test. I guess my problem is trying to find the number, fine-tune a number that works for everybody in every region in every economic circumstance. The QTL test is sort of like a blunt instrument and I'm not sure it was ever designed to be used like a scalpel. I think the way you deal with lending beyond housing is with capital. I think it's the capital standards and very strict enforcement of the regulations in other than nonsingle family lending that's the issue, rather than trying to decide whether it's 60 or 70 or 80 percent or some other number. I think 60 percent is just as good as any other number, as long as you really make them use their own money when they're dealing with the other 40 percent. And I think the ability, in effect, to choose within that 40 percent basket—to find what works in a given market—is important.

As an example, in Texas today, you certainly wouldn't want to be going out and funding new commercial construction, new office buildings as an example. On the other hand, the Houston market has stabilized and residential construction in certain markets is coming back. So the process of financing housing is more than making the loan. Somebody has got to make the construction loan and land development loan. In some cases, I would think that in the Houston market as an example, you could do that where you shouldn't be lending for office buildings. I think there are other people who are perfectly good at investing in junk bonds. I don't know how you determine from afar what's right for everybody.

I just think you need to make sure that they do it with their own money and that you supervise it very closely.

I guess that's my answer to that particular question.

In conclusion, I would simply say that whatever the outcome of all of these issues, and whatever the additional assessments, with which you know I agree, I hope that we can do this in a relatively short but deliberate period of time because the situation, at least in the State in which I am, is exceedingly serious. We have institutions borrowing for 6 months at 10.75 percent and obviously those are the insolvent ones and it's not their money; it's the Government's money they're spending. I can only imagine how that increases the cost of the solution every day, much less the fact that it grosses up the Texas index off which the $40 billion of premiums are based.

When you think about the multiplier effect of these guys going and paying 10.75 percent for money, it gets scary. And I'm not sure that they're getting any more money at 10.75 percent than they would have got at 10.5 percent. I'm not sure that the issue is the rate rather than the lack of confidence.

Thank you.

[The complete prepared statement of Lewis S. Ranieri follows:]

TESTIMONY OF
LEWIS S. RANIERI
PRINCIPAL, RANIERI WILSON & CO., INC.
BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
MARCH 17, 1989

Introduction

Mr. Chairman, Members of the Committee on Banking, Housing and Urban Affairs, my name is Lewis S. Ranieri. I am a principal of Ranieri Wilson & Co., Inc., a financial services and real estate investment firm. I am also Chairman of the Board and Chief Executive Officer of the United Savings Association of Texas FSB, a Houston-based thrift institution with over $4 billion of assets.

I appreciate your invitation to testify today on the provisions of S. 413, The Financial Institutions Reform, Recovery and Enforcement Act of 1989, and on the relationship of that bill to the need for and future of the thrift industry.

Overview And Summary

The Congress is engaged in a task of vital importance - - restoring our nation's deposit insurance system to financial health. The Administration's bill represents an excellent starting point for that process, although there are a number of specific changes to the bill that I believe should be made, particularly from the standpoint of assuring the continued availability of mortgage money for the American homebuyer at reasonable interest rates. More important than any particular detail, however, is the need for Congress and the Administration to resolve this problem, and to resolve it speedily. We have been fortunate so far that public confidence has not been permanently undermined by the flurry of news reports surrounding the FSLIC's problems. But confidence levels have already begun to erode seriously -- as reflected in the premium rates that must be paid for deposits at many thrifts. Those excessive rates increase the cost to the Government of closing insolvent institutions, and increase the difficulty of meeting any increased capital requirements for solvent institutions. If we are to prevent the costs of the problem from growing even further time is very much of the essence.

Congress and the Administration have made it clear they would consider inadequate any plan that solves the FSLIC's current cash crisis without at the same time making the supervisory and regulatory changes necessary to avoid a recurrence of the problem. The Committee has asked me to address those possible changes with particular reference to the question of whether this country still needs a separately regulated thrift industry as a specialized housing lender. Let me try to summarize the principal points of my testimony.

1. Our country's system of providing mortgage money for housing continues to be dependent on the existence of thrifts as specialized housing lenders. The thrifts' role is of central importance to housing, notwithstanding the development over the last decade of a strong secondary mortgage market. Accordingly, the Congress needs to weigh carefully the impact of its actions on the continued availability of mortgage money at reasonable interest rates. Fortunately, achieving this goal need not conflict with Congress' other objectives since residential mortgage lending has not been the source of the problems leading to the FSLIC's insolvency.

2. Although the Administration's bill is generally sound, there are several specific problems with S. 413 that must be addressed in order to avoid inflicting a level of damage to the thrift industry -- and to the availability of mortgage money -- that I believe the Congress would not want to impose. The most important changes to S. 413 relate to the need for Congress to make its own legislative judgments regarding the level of costs to be exacted from the thrift industry, and indirectly from the housing sector. Even more important than the specific level of costs or burdens imposed on the thrifts is the need for Congress to establish the appropriate level of such costs statutorily, and not to delegate an open-ended grant of authority to regulators and deposit insurers to exact additional costs without additional legislation.

3. Specifically, I would make the following recommendations:

o Deposit insurance premium rates should be statutorily established by Congress, not set by the insurance agencies. This is essential to assure those putting new capital into the thrift industry that substantial additional premiums cannot be imposed on the industry by administrators or regulators without subsequent Congressional action. An open-ended premium structure will drive away those who would otherwise be willing to invest new capital in the industry.

o The Treasury Department's proposed oversight over the newly constituted Federal Home Loan Bank System should constitute a supervisory role only, and should not allow Congressional decisions regarding housing policy and the lending policies of the Bank System to be overruled or watered down by administrative action. The system of providing Home Loan Bank advances to member institutions is crucial to the goal of keeping mortgage money available and affordable for the American homebuyer. A Congressional policy decision to preserve this System should not be reversable by the Executive Branch.

o The levies which the bill would impose on the capital of the Home Loan Bank system should be reduced. A substantial upfront levy on the system in a fixed amount is acceptable, although the $2.7 billion levy proposed by the bill may be excessive, particularly in light of the System's present capital levels. In any event, the bill's additional ongoing levy of up to $300 million annually for an indefinite period would forestall internal capital growth and drive away new sources of capital. If the size of the thrift industry shrinks, as would be expected from the enactment of other provisions of the bill, a $300 million system-wide levy would become an increasingly severe charge passed through to each of the surviving members of the industry.

o Finally, as I have stated, more important than any particular detail is the need for a speedy resolution of this entire matter, in order to restore depositor confidence and stop the silent, but devastating, drain on thrift earnings caused by the present uncertainty.

The Need For A Separately Regulated Thrift Industry As A Specialized Housing Lender

I have spent 15 years of my professional career helping to build, essentially from scratch, what is now a highly efficient secondary market in mortgage-related securities. That market has increased the availability of mortgage money at reasonable interest rates by creating new forms of mortgage-related securities that have contributed to the liquidity of mortgages in the hands of thrifts and other portfolio lenders, and has also successfully attracted new money from pension funds, insurance companies, and other long-term institutional investors who might otherwise have invested in corporate bonds.

As many of you know, I have worked with this Committee, and its counterparts, on securities and tax legislation to help improve the efficiency of the secondary mortgage market. I am speaking, of course, of the Secondary Mortgage Market Enhancement Act of 1984 and the REMIC provisions of the Tax Reform Act of 1986, legislation that the Congress should view as significant accomplishments for housing. Consider for a moment that despite all of the turmoil surrounding the FSLIC crisis we are not in any sense facing a shortage of mortgage funds.

As one who has spent much of his professional life building and nurturing this important market I can tell you that the secondary mortgage market was never intended to supplant the role of the thrifts as housing lenders -- and indeed it cannot do so in the near term without significant dislocation and cost to the housing finance system.

The continuing need for the thrift industry hinges on the fact that the secondary mortgage market, despite its successes, has not and will not eliminate the need for institutions or individuals to actually lend money. We have succeeded, with the help of Congress, in developing specialists in the origination of mortgages, in the packaging of mortgages into securities, in credit enhancement techniques, and in the issuance and trading of mortgage-backed securities. But, like the battle that was lost for want of a nail, the whole marvelous process means nothing without a lender at the end of the chain, someone standing ready to put up the funds that ultimately go to the homeowner or the builder. This is part of the role that the thrifts must continue to play.

The Federal secondary market agencies, in particular, are issuers and guarantors of mortgage securities, not lenders for the most part. None of the more recent arrivals to the mortgage capital markets were designed to be complete substitutes for the thrifts' lending role, and the secondary market would be unable to maintain the current flow of funds to housing absent the thrift industry's continued willingness and ability to hold a substantial volume of residential mortgage loans and securities for investment. Congress can reform the tax or securities laws, but it cannot repeal the fundamental laws of supply and demand.

A careful look at the statistical record bears this out. In 1970, before the emergence of the secondary market as we know it, commercial banks held in portfolio approximately 15% of the outstanding single-family mortgage loans, and mortgage bankers held approximately 2%. By the end of last year the commercial bank share of the market was essentially unchanged (estimates range from 15% to 18%) and the mortgage banking share had actually dropped to 1%. During this period the secondary market has enabled insurance companies, pension funds, and others in the non-bank, non-thrift sector to increase their participation as ultimate lenders of mortgage money. But the thrift industry continues to be the single largest sector, holding in portfolio approximately 44% of the entire single-family residential market. The growth of the non-thrift, non-bank sector occurred largely in the decade between 1978 and 1988. In my judgment that growth cannot be expected to continue, or to continue sufficiently rapidly, to accomodate the current demand for mortgage money without the thrift industry. And, as I have indicated, the commercial bank sector has been relatively flat for the last twenty years. As a result, any significant reduction of the ability or willingness of thrifts to hold residential mortgage loans and mortgage securities -- or in the sheer number of thrifts -- would be cutting "into the muscle" of the mortgage lending market and would, in my judgment, severely impact the availability of mortgage money at reasonable interest rates.

The thrifts' contribution is not only quantitative, but qualitative as well. In addition to holding in portfolio almost half of the single family residential loans and related securities the thrifts continue to originate about as many single-family and multi-family loans as the mortgage banking sector and commercial banking sector combined. The existence of financial institutions that are not only committed to the business of originating home loans, but that also have the capability and willingness to act as portfolio lenders -- year in and year out -- provides a degree of steadiness, reliability and creativity that is irreplaceable. Consider such innovations as the 15-year mortgage, the bi-weekly mortgage, and the adjustable loan convertible to a fixed rate, which I believe might not have developed without the creativity and competitiveness provided by thousands of independent financial institutions committed to the business of residential lending in good times and bad.

In bad times, without the thrifts to act as a buffer, homebuyers would be forced to compete directly with other borrowers in the capital markets. While the secondary mortgage market has helped to tap those markets for mortgage lending, the inescapable fact is that most loans made by commercial banks bear a substantially higher interest rate than home mortgage loans. If homebuyers are forced to compete directly with business borrowers paying two or three points above the prime rate, or charge card borrowers paying sixteen or eighteen percent, mortgage interest rates cannot help but rise -- even if interest rates generally remain flat.

In addition, many thrifts structure, issue, and service a significant portion of the mortgage-backed securities that are sold as "bond-like" investments in the secondary market. As active managers of their portfolios thrifts have the ability to use derivative securities, which cannot easily be sold to institutional investors, as tools for hedging undesirable portfolio risks. Without thrifts and other investors willing and able to make prudent and effective use of the all of the tranches produced by the securitization process, the benefits of innovative multiple-class securities made possible by recent legislation would be severely reduced.

The Viability of Thrifts as Specialized Housing Lenders

In my view the desirability of preserving the thrift industry as a specialized housing lender is thus beyond question. But is such a specialized housing lender viable -- ten years shy of the turn of the 21st century? As a businessman who spent more than 15 years as an investment banker building the secondary mortgage market -- and who has just become the Chairman and CEO of a $4 billion Texas thrift -- my answer should be an obvious "yes". Let me briefly explain some of the reasons for my belief.

First of all, the housing finance activities of the thrift industry, with very few exceptions, are not to blame for the industry's dramatic losses during the past decade. As the Members of this Committee know, investments concentrated in non-residential real estate and non-real estate assets account for most of the FSLIC assets acquired from insolvent thrifts and for the majority of the nonperforming assets of the insolvent thrifts that regulators cannot now afford to close. Too many thrifts invested in these assets with little or no relevant experience and hardly a greater degree of competent supervision. Historical losses attributable to residential mortgage investments, even during the interest rate crunch of the early 1980's, were small by comparison.

In the context of a significant national or regional economic downturn, no financial institution, no matter how diversified or how specialized, will escape completely unscathed. Thrifts in Texas have suffered, to be sure, but so have virtually all other businesses there. A number of highly rated Texas commercial banks, including at least one that a enjoyed "Triple-A" credit rating, suffered significant losses that ultimately led to their acquisition by bank holding companies or other investors.

Most importantly, residential lending is not merely "safe". Well-capitalized, well-supervised, and well-run thrift institutions remain highly profitable. As a businessman that is why I have decided to invest in the thrift industry.

Funding The Clean Up - In General

What then does all this mean for the present effort to restore the financial health of the deposit insurance system, for the question of who should bear the costs of that effort, and for the question of how best to avoid a recurrence of the present problems?

It is certainly appropriate for the beneficiaries of Federal deposit insurance to pay a reasonable price for the benefits that deposit insurance provides. Deposit insurance, by guaranteeing the safety of deposits, reduces an insured institution's cost of borrowing and a deposit insurance premium for that benefit is certainly appropriate. When it comes to cleaning up problems of the magnitude we are facing, however, some will point out that there are many healthy thrifts that had nothing to do with causing the severe problems we face today. Indeed, the management of some institutions were vocal opponents of the lax supervision or permissive regulation that contributed to those problems. On the other hand, the taxpayers certainly did not cause those problems either. Unfortunately we cannot expect to recoup the costs of the clean up from those truly culpable for the mess.

To a certain extent, then, Congress is facing a moral or political choice with no easy or self-evident answers. And I have no facile advice to offer on that score. I can say this, however. Whatever the appropriate "moral" or "political" level of costs to be imposed on the thrift industry, Congress must realize that it does face a number of purely financial constraints. The decision to impose any particular level of new costs on the thrift industry -- be they in the form of insurance premiums, capital requirements, or regulatory changes -- is also a decision to "kill" a portion of the industry that is currently marginally solvent and that might otherwise survive.

The failures of some of these institutions could be expected to add to the total costs borne by the government. In addition, a decision to reduce the size of the thrift industry means that there will be even fewer institutions left to bear the clean up costs Congress hopes to allocate to the industry. Thus at some point "killing" too many marginal thrifts will increase, not decrease, the share of costs that must be borne by the taxpayers.

Most importantly, as I have tried to demonstrate, a decision to reduce the size of the thrift industry is not merely a short-term political issue. It necessarily involves some long-term risk to the continued availability of residential mortgage money. That may be the most tragic aspect of the decision facing the Congress -- since residential lending is not the culprit. In that framework, then, let me proceed to some specific comments on the provisions of S. 413.

Thrift Industry Deposit Insurance Assessments

One of the bill's provisions aimed at restoring stability to the thrift insurance fund is a requirement that thrift deposit insurance assessments remain at their current level of 0.208% through 1990, increase to 0.23% for the period from 1991 through the end of 1993, and then remain at 0.18% beginning in 1994 and thereafter. Adequate deposit insurance premiums are appropriate for the benefits of Federal insurance. Payments at this level, though not welcome, are probably tolerable for the near future. An open-ended assessment, however, under which the industry could be subjected to further increases for the indefinite future, would surely cripple the industry's ability to raise new capital.

In my judgment investors simply will not inject capital into a business where there is a real threat that administrative action could result in the confiscation of earnings for the indefinite future. The threat of an indeterminate levy on future earnings is a significant disincentive to investment. Moreover, thrifts will be unable to generate capital internally if too much of their earnings are siphoned off in assessments.

To avoid this problem, the plan approved by the Congress must establish by statute the specific levels of insurance premiums to be borne by the industry. Increases from statutorily prescribed levels should be possible only through subsequent legislation, not administrative action.

Finally, for reasons of competitive equity, the thrift deposit insurance assessment level should also eventually be made equal to that of commercial banks.

Capital Levels

I strongly support the bill's concept of requiring adequate capital for thrift operations. These provisions are the most important parts of the plan as far as the future of the industry is concerned. I believe that the proposal to increase capital to approximately six percent of risk adjusted assets by 1991 is unrealistic, however. In my judgment the proposed capital levels of S. 413 are correct, but the plan should generally extend the phase-in of those requirements through June of 1993, a schedule which I believe would offer a realistic chance of achievement for the majority of institutions. In addition, a longer period may be appropriate in some cases.

As has been reported recently in the financial press, the capital levels mandated by the bill would require the industry to raise between $20 billion and $35 billion in the next two years. The high point of this range, $35 billion, is almost nine times the amount of capital raised by the industry in the two year period ending in 1988. I use that recent period as a comparison because that was a time in which lower interest rates made issuance of new equity much easier than it may prove to be in the near future.

Raising the capital requirements is critical to avoiding recurrence of the current problems. Industry capital is the first line of defense against losses to depositors, and thus protects the insurance funds from losses. However, establishing an unrealistic schedule for increasing capital levels will be counterproductive at worst, and at best will leave us with a politically messy compliance problem in 1991. Congress certainly has the power to establish tough capital requirements with onerous penalties for non-compliance, but it cannot repeal the laws of economics.

There are also a number of administrative or regulatory steps that would promote capital growth in the industry. First, as many others have said, closing insolvent institutions will permit the survivors to operate without unfair competition for deposits from institutions that are free to bid up rates because they have "nothing left to lose." Achieving quick closure of insolvent thrifts, especially in geographic areas where a number insolvent thrifts, especially in geographic areas where a number of such institutions are concentrated, should lower funding costs and other expenses of the remaining healthy institutions. This action should increase the profitability of the surviving institutions -- and stable profits are the best guarantor of increased capital levels.

Whatever schedule is adopted for raising capital levels, a second appropriate step would be the elimination of some of the existing legal barriers to investment in thrifts, at least as those barriers apply to capital-poor institutions. In this regard I note that Representatives LaFalce and Barnard have introduced H.R. 949, which would expand the abilities of healthy savings and loan holding companies to provide new capital to weak, but still solvent, thrift institutions. Measures such as this one, which eliminates an investment restriction that is not justified in the case of weak thrifts, will permit injections of private capital into institutions before they land on the deposit insurer's doorstep and increase the ultimate cost of the FSLIC resolution.

Finally, given the large amount of goodwill generated within the industry due to assistance transactions, the legislation should permit amortization of "supervisory" goodwill over at least a 15-year period rather than ten years as proposed. In some cases a longer period may be appropriate. This change would avoid punishing institutions solely because they sought to be part of the solution to the industry's problems.

Supervisory Changes and Accounting Requirements

The proposal to make the Federal thrift regulatory system subject to Treasury Department oversight is appropriate, provided that the policies of the Federal Home Loan Bank System concerning housing finance remain the prerogative of the Congress. Congress has made a legislative policy decision that the Bank System should provide assistance to mortgage lending through the System's advances to member institutions. Because of the importance of those advances to our system of housing finance, there is no reason for Congress to change that policy decision. Indeed there is no proposal to do so. But Congress must also ensure that the Treasury Department is not empowered by its oversight role to water down or reverse that policy decision.

The bill would require that regulatory accounting practices and supervisory standards for thrifts conform to those applicable to commercial banks. I strongly support doing away with the accounting practices and other compromises that have allowed some thrift managers to obscure their institutions' operating losses and lack of capital. There is no benefit to the industry or the public when such conditions are permitted to continue until the losses become too large to eliminate without disrupting the rest of the industry and the financial system.

accounting practices that distort thrift financial information and strengthening supervision of the industry. These steps are essential both to preserving the system for housing finance and to avoiding similar problems in the future.

The bill includes proposals to strengthen the "qualified thrift lender" test in certain ways. The present requirement, under which thrifts must invest at least 60% of their portfolios in housing-related assets, is an appropriate minimum which should not, in my judgment, be increased. The problem with raising the 60% requirement is not that a higher level might not be desirable or appropriate in general, but that it is too difficult to determine a precise number that will accommodate varying economic conditions of particular thrifts and differing regional economies. Figuratively speaking, the qualified thrift lender test is a "blunt instrument" that is ill-suited for such fine-tuning. Instead of changing the 60% requirement it would be better to focus on the remaining 40% through stringent risk-based capital requirements and diligent supervision. Imposing a rigid requirement that non-residential lending activities be backed by an adequate amount of the institution's own capital, and diligently supervising compliance with such requirements, is the best defense for the insurance funds. The proposed FHLBB regulatory amendments would achieve this result.

Effects of the Legislation on the Home Loan Bank System

The bill would adversely affect the Federal Home Loan Bank System in two ways.

First, it would require the use of significant amounts of the capital of the Home Loan Bank System to finance the resolution of insolvent thrifts. As a political matter I recognize that using some of these funds is necessary. But an open-ended claim on this equity would impair dividends to member thrift institutions and therefore hamper their ability to raise capital. Excessive depletion of Home Loan Bank System funds may also force member thrifts to write down their holdings of Home Loan Bank stock, resulting in immediate losses and increasing the industry's financial problems. Each of these conditions amounts to an additional assessment on the thrift industry. It is conceivable that such charges against thrift income could increase the number of thrift institutions needing Federal assistance. A plan producing this result is clearly not cost-effective.

The proposal in the bill to exact a substantial upfront levy in a determinable amount is acceptable. The $2.7 billion upfront levy contemplated by the bill may be excessive, however, particularly in light of the level of capital currently in the System. More importantly, the System cannot also be expected to devote up to $300 million in each subsequent year for an indefinite period without experiencing the difficulties I have noted. Accordingly that open-ended levy on the Bank System should be eliminated from the plan. Such an ongoing levy would forestall internal capital growth and drive away new sources of capital. Indeed, if the size of the thrift industry shrinks, as would be expected from the enactment of other provisions of the bill, a $300 million system-wide levy would become an increasingly severe charge on each of the surviving members of the industry.

In addition to hurting the surviving thrifts, siphoning off too much of the System's capital would effectively eliminate the System as a source of funds for housing. The System provides a major portion of the funds used by the thrift industry for housing finance. Thrifts, unlike commercial banks, generally cannot issue jumbo certificates of deposit or commercial paper in the capital markets to supplement their core deposits, because very few thrifts have adequate unsecured debt ratings. The Home Loan Bank System makes up the shortfall by lending funds to member institutions. Excessive use of System capital to resolve insolvencies could impair the System's ability to borrow in the capital markets. And if this aspect of the System ceases to function, the healthy part of the thrift industry cannot be expected to continue to function as residential lenders.

Conclusion

I have addressed to some extent the issue of the level of costs that can realistically be borne by the thrift industry. While I believe S. 413 has some excellent provisions, I think the bill's reliance on the industry is excessive, particularly as it relates to the open-ended nature of the potential costs to be imposed on the industry.

The plan to impose certain costs on the thrift industry assumes the continued health of the solvent members of the industry. Unfortunately, the act of imposing those costs will contribute to insolvencies and reduce the size of the thrift industry. By reducing the size of the industry the proposed solution will further increase the costs allocated to the industry as a percentage of thrift assets, presenting the possibility of a vicious cycle. My basic view is that if the healthy thrifts are to contribute financial resources to the solution, the proposal should not bankrupt too many of them in the process. In addition to increasing the overall cost of the clean up, the adverse effects on the availability of mortgage money could be quite serious.

In the long run, after the present crisis is dealt with, I believe the Congress must decide whether it really wants a system of insured depository institutions like the present one. If it does, the Congress must eventually equalize operating costs among competing insured institutions, and between insured

institutions and their unregulated competitors, including money market mutual funds. For example, there is a good case for subjecting money market mutual funds to reserve maintenance requirements that would help to equalize their competition with regulated depository institutions.

Ultimately, after the thrift industry has paid for the errors of some of its members, it should be able to look forward to fair competition, with everyone playing by the same rules. That is the key to assuring that our current problems do not recur. Unless we move substantially closer to a true "level playing field," we can have no such assurance.

The CHAIRMAN. The three of you have given us a lot to think about. I want to make one comment and then see if Senator Pressler has any opening observation he wants to make. Then, I will ask each of you, briefly, to respond to some of the points the others have raised.

One of the things I am hearing is that if we were smart enough to devise a much better supervisory and regulatory system, you could then have a system that had more flexibility and more ability to have higher risk components in it. The logic of that certainly makes sense.

The question is, is it feasible? Does history tell us that it is feasible to craft a regulatory system that has so many talented people that it can cover 50 different States with 50 different sets of rules with Government-insured deposits. That they would be able to go in, do the audits, do them all the time, be up to speed on what is going on here, and really track this industry. It seems to me that there is a crossover point between what you write into the law, which gives you the boundary lines of an industry, and the degree to which you widen those way out and say, well, we'll just have a top-notch regulatory system. We will have a much broader playing field, a much more mixed set of risk profiles situations, and we will count on the regulators to do a bang-up job.

I've got to tell you, I don't have any confidence in the regulatory system being able to have enough people with enough talent every day of the year, year in and year out, to monitor that kind of system. Here we are, we wake up now and find $100 billion has disappeared. Just speaking as one person, I have a very hard time allowing myself to believe that suddenly we can craft this enormously more effective regulatory system, put it in place, keep it there, and suddenly it will do a policing job that all the recent history tells us we were miserable at doing.

It taxes my imagination beyond the point of where I don't want to risk a $100 billion but even another $10 billion, in terms of what the taxpayers would be susceptible to having to pick up. But that is just a little comment.

I want to acknowledge the colleagues that have come in. Senator Pressler, did you have an initial point you wanted to make.

Senator PRESSLER. I do not have an opening statement. I will have some questions for the record. If I am here when my turn comes, I will ask them.

The CHAIRMAN. Very good. Thank you. Senator D'Amato, did you have an opening comment to make today?

Senator D'AMATO. It is nice to see such a distinguished panel. Luigi Ranieri——

[Laughter.]

Senator D'AMATO [continuing]. Who has made his comeback in such an auspicious way. A great entrepreneur. I look forward to asking him a few questions when we get into the panel.

I am wondering, Mr. Chairman, I missed the—did somebody—did my grandson—by the way, I want you to know that I am the father of Mrs. Murphy. I want you to know, Lisa, ran down this poor, unsuspecting Irishman by the name of Jerry Murphy. So I am the father of Mrs. Murphy, and that looks like little Gregory Murphy's building blocks or something here. Did you already do this presentation?

The CHAIRMAN. Well, we've got it on videotape for you.

Senator D'AMATO. All right.

Mr. SANDLER. I would be willing to do it again, if you want, Senator. [Laughter.]

Senator D'AMATO. No, no.

The CHAIRMAN. Your comment about Mr. Ranieri is interesting, because he is now testing his entrepreneurial skills to be able to go out and raise deposits of 10¾ percent in Texas and make money on them, and he is finding it a very taxing exercise.

May I suggest that we will take about 5 minutes a piece to allow you, Mr. Sandler, to react to any of the comments that the others have made. You have had the benefit of hearing their comments and anything that you would like to agree with, strongly disagree. We will follow that through with the other two. I want to stay within bounds because we've got a number of members, and they do have questions.

Mr. SANDLER. I didn't know whether you wanted me to comment on the State issue or should I leave that for later?

The CHAIRMAN. Well, I would like you to do two things. I would like you to react to anything that the others have said that you think needs to be highlighted. Also, one of the things we have got to get back to is if there are critical defects in the administration's plan. You have obviously taken a lot of your initial time to point out ones that you think are there. I think we have to try to get down to a basic understanding of what the things are that, in the view of each of you, have to be adjusted, and is there any consensus among the three of you as to the things that are the most important to adjust, so that we've got a working plan.

ADJUSTMENTS TO THE PLAN

Mr. SANDLER. I think it is clear what is the most important to adjust. I think we have all spoken—as different as our points of view may have been in specifics, in a general way, I think they were fairly clear on at least one of these items. The concept of a regulator having the right to increase a premium is sheer insanity and will, without any question whatsoever, stop any further capital from coming into the industry. I don't know where that idea came from, but they ought to toss it out as fast as they possibly can.

The second conceptual issue is this. I mean, obviously, those of us who have been screaming about this problem——

The CHAIRMAN. Let me just ask you just one thing on that.

Mr. SANDLER. Sure.

The CHAIRMAN. Your colleagues may want to get into that too. If you are going to fix the premium schedule in law, then, in effect, what you are also defining is the scope of the business. I think that has to go with it. And then you would say to the regulator that if anybody gets beyond the scope of that business or demonstrates that they can't operate prudently or profitably or effectively, you take their charter away? You just shut them down?

INSURED DEPOSITS

Mr. SANDLER. Insured deposits are a privilege. You don't use insured deposits for anything you want to use them for. You don't use them for speculative activities. You don't use them for drilling oil wells or making loans on stud farms or direct investments. Insured deposits should perform some kind of public purpose like, in our case, making residential loans. So if you want the right to have insured deposits, you tell them what to do. You will do the following things, giving enough leeway in other reasonably conservative activities, so there is some flexibility. But the idea that I want to engage—let's take something as hot as junk bonds. There is no God-given right to use insured deposits for junk bonds. If I want to invest in junk bonds, use my money, my own real capital. What is the public function served by investing in junk bonds?

I mean, I never heard such insanity. It makes no sense. You restrict the charter so that there is a reasonable safety allowance with it. My colleague on the left will probably suggest junk bonds may be safer, even if they were safer, what is their relationship to the use of a financial intermediary touched with fiduciary responsibilities making junk bonds, investing in them? Where is the public purpose? What is being served. There is plenty of money around. My God, the economy is awash with investable funds in junk bonds or in direct investment. I don't even begin to understand the issue.

The CHAIRMAN. Well, let's find out what it is. Mr. Fleischer, why don't you respond to that point.

Mr. FLEISCHER. Well, first the mortgage itself is an extremely risky asset in a very simple industry of making fixed rate, fixed term home loans. Our industry, as the result of a change in market interest rates, sustained an economic loss of $250 billion in the early 1980's. So that I don't think the issue is what is risk and what is not risky with respect to an investment but rather how that risk is being managed. If what we sought was a way in which to provide for the safety of consumers' deposits and only that, we could do that by mandating an investment in maturity matching investment grade obligations. This is one of my suggestions with respect to a basic bank. If we want, however, to provide that another purpose for insured deposits is to fuel economic growth, I think then that we would allow insured deposits to be used for any purpose consistent with economic growth where the institutions are managing with prudence and safety.

By reference to the rating agencies, the overcollateralization using pools of home loans that are guaranteed by a government agency with no credit risk is approximately 135 percent. For a properly diversified portfolio junk bonds, it is approximately 200 percent. Accordingly, the rating agencies have determined that the relative risk of junk bonds to home loans where the credit risk has already been eliminated, is approximately three times. I believe that the risk-based capital regulations can address that issue appropriately.

The CHAIRMAN. Let me just ask you, Mr. Ranieri, to chip in your view on that topic. Then I think I will go to the questions, because I think we will get to focus on points faster.

Mr. **Ranieri.** I believe if thrifts are allowed to exist, it is because they are founded in housing lending and the parts of housing lending that are required, which, by the way, in my mind, is more than just making a loan, but all of the parts of housing. Beyond that, the question is, if they only do housing to the exclusion of everything else, is that a viable franchise?

My answer is no, I don't think so. At least not in every jurisdiction. So I don't really have a problem with diversifying to a point the other things they do, as long as they do them prudently, and frankly, in response to your comments, I certainly am not against reregulation, because I think the answer, by the way, is no, you can't have supervisors that find everything in the world. I think the issue is, what reregulation you do, where and how, but I think there is a certain amount of reregulation which, by definition , has to go on, given what we have seen, you know, seen occur here. I can't imagine having a thrift with 100 percent junk bonds. I would have to agree with Herb. We don't need thrifts that do 100 percent junk bonds. Thrifts have to be primarily in housing. I agree with Herb in that regard.

The **Chairman.** Should they do any junk bonds?

Mr. **Ranieri.** Should they do any junk bonds? I guess I don't have a problem with them doing some junk bonds. My head tells me it is more logical, since they have the Government umbrella, to see them do something that other people are not set up to do. I mean, pension funds are set up to invest in junk bonds, as an example. Pension funds are not set up to do construction lending. So if you said, is it more logical to do construction lending than junk bonds, I mean, the answer is, yes, logically, that is why they got the shingle in the first place.

But if somebody wants to say, well, in my jurisdiction, I don't have enough of these other things to do, so I want to put some finite limit of my portfolio in junk bonds, I guess I don't emotionally fall out of bed. If he said it was 50 percent of the portfolio, you know, or 40 percent of the portfolio, I guess I would have to wonder whether we need him around as a thrift. Although I have nothing against junk bonds.

The **Chairman.** I have had a chance, in a sense, to pose a comment and a question. I am going to now start down the table. Let me start with Senator Cranston, and then I will go next to Senator Kassebaum. Yes, Senator Cranston.

Senator **Cranston.** Thank you, Mr. Chairman. I would like to ask you, Herb, if you want to comment on what Mr. Fleischer said in response to what you said. [Laughter.]

Mr. **Sandler.** Thank you. Well, what Mr. Fleischer presents is an extraordinarily unique view of a rather unique individual. He is obviously extremely brilliant, and he has performed over a period of years in dealing in what I would regard as an arcane manipulation of the mortgage- backed securities world, and he has been extremely successful at it. My comments, standing apart, would be that it is still an untested theory even as to Mr. Fleischer, because he has not really gone through a cycle. I regard a cycle as when you get into 10 or 15 years of performing of something and then step back and see whether it worked.

But the second question I would ask is, (a) is there another Mr. Fleischer around who can do that, and (b) if there were a number of Mr. Fleischers around who can do that, should they be able to perform that particular activity with insured deposits?

Senator CRANSTON. Herb, how do you think we should pay what the Government is now obligated to pay? What source should we turn to and to what degree——

SOURCES GOVERNMENT SHOULD USE TO PAY ITS OBLIGAITON

Mr. SANDLER. You know, it is interesting. Let's be frank about the administration plan. They came up with a concept and then they ran out to look to see if the numbers supported it. And that's the truth. If you have seen any of the material that the Treasury has submitted around, and I saw something they handed out just last week, and about 90 percent of the numbers were actually wrong numbers. That is kind of scary at this stage of the game to see that level of error. I am not talking about the conclusions they are drawing. I am saying the material presented to be reviewed was factually inaccurate. I get a little worried when that happens at this stage of the game.

The GAO and the CBO have actually made a proposal for you, and I don't understand why somebody hasn't picked up on it. They say all the losses should be funded on budget by the Treasury. The second thing you do is that my new FSLIC fund be built by the industry. Penalize us as hard as you want. If we did something wrong by being members of the U.S. League and you want to hit us or we're in the nuclear war zone and you want to nuke us, nuke us, but put the money into the new FSLIC fund. If you do that, you protect against future problems. The other advantage of funding it directly is that you can close the institutions immediately.

The GAO points out one thing, which is a world I don't deal with. They point out that if you do this before September 30, it doesn't trigger Gramm-Rudman.

So my God, the formula is here, and you can get as much money out of us as you want, but put the money on budget, save the financing costs of the off-budget tricks, smokes and mirror game, and why don't you deal with it directly? Everybody knows what it is. It is paid for. It is honest, and frankly, the public will buy it. What scares members of the public is when you guys go off budget, and we don't know what you did. When you create income out of losses, I get a little mystified. It is here. Two good authorities have done the work on it. It has actually been done. Why not use it?

Senator CRANSTON. Mr. Fleischer or Mr. Ranieri, any comments on Herb's comments?

Mr. FLEISCHER. In response to Mr. Sandler's comments, the skills which I had in 1981 were nil with respect to this activity. We recognized at Franklin Savings Association that we had $200 million in liabilities and 40 percent less than that in the value of assets. Our concern at that time was that by the time accounting conventions caught up with economic reality, the public would have forgotten what really caused the losses. We were very worried about our own personal reputations, and our plan at that time was to resign and turn the operation of that institution over to the Topeka

Federal Home Loan Bank, because we did not want to run an institution that was economically insolvent.

To support that decision, Dwayne Hall, who was then Franklin's president and still is, recommended that we retain as a consultant an economics professor at the university in Ottawa, KS, where our home office is located, and his name is Wayne Angel. Dr. Angel worked with us from 1981 until January 1986, when he became one of the Governors of the Federal Reserve. Dr. Angel taught us how to do this. None of us had the skills prior to that. These skills are not skills which extraordinary human beings have to have. These are skills which people with ordinary finance backgrounds can learn. It is important that these skills be learned and that we not have a repeat of what occurred in 1981 in our industry.

Thank you so much.

Senator CRANSTON. Lew, any comments from you?

Mr. RANIERI. Very quickly, Senator. The thing I guess I think most about, is four steps. The first thing you do is minimize the losses. Frankly, we are not minimizing losses right now. The answer is, first minimize the losses. And we are letting the losses spiral, as I said earlier, I think, somewhat out of control, in terms of the way this situation is being handled in the interim.

The second half of that is then maximize the cost of the thrift industry to the point that you don't cost yourself more losses than the money you are getting.

Third, and I think, most importantly, maximize the value of the assets that you are laying hands on, which so far, in my opinion, has not really been done. OK?

If you do those three things, unfortunately, beyond that, the answer is the taxpayer. But that will give the lowest cost to the taxpayer.

We have been arguing about how much or how little is right for the thrift industry, forgetting the first, minimizing the losses, which is maximizing the assets that you are laying hands on.

Senator CRANSTON. I thank the three of you. Your comments have been very instructive and helpful. Marion, I want to say that we welcome you also to this session, and in light of what has been said, do you want to make any adjustments in what's in the baskets or knock anything more off the table? [Laughter.]

My time is up, Mr. Chairman.

The CHAIRMAN. Senator Kassebaum.

Senator KASSEBAUM. Thank you, Mr. Chairman. Well, it has been a most interesting panel. Of course, I am very proud to have part of the panel, Mr. Fleischer, who has provided extraordinary leadership not just in Kansas but his influence is felt way beyond the Kansas borders. There is a statement of welcome that I would like to ask be part of the record that Senator Dole has made.

The CHAIRMAN. Without objection, it will be made part of the record.

STATEMENT OF SENATOR BOB DOLE

I wish I were able to be here today to introduce a fellow Kansan—Ernest M. Fleischer, chairman of Franklin Savings Association in Ottawa, KS.

—

Mr. Fleischer has had an outstanding track record as chairman of Franklin. During his tenure at Franklin, Mr. Fleischer has truly become one of the outstanding business leaders of Kansas, transforming Franklin from a business with approximately $200 million in assests to one with assets worth over $9 billion. This growth has been the result of the type of prudent and thoughtful investment that has typified Mr. Fleischer's policies as an executive in the savings and loan industry.

I am sure that Mr. Fleischer's testimony will be of great interest and value to the members of the committee as you attempt to sort out and resolve the problems currently plaguing the savings and loan industry.

Senator KASSEBAUM. It seems to me that there are three things that at least everyone agrees on and that is that it is very important that an institution be properly capitalized.

If I may start with Mr. Fleischer in a question first, because you talked about—I believe in your statement that the increasing capital will not necessarily eliminate the problems of the interest rate risk. Is there not a relationship between capital and financial safety?

RELATIONSHIP BETWEEN CAPITAL AND FINANCIAL SAFETY

Mr. FLEISCHER. There most clearly is a relationship between capital and financial safety. I believe, however, that that capital is a false signal of comfort, because the risks involved in home lending are enormous compared with the amount of capital that is reasonable for a financial intermediary to have. Again, with reference to what existed in the regulated era prior to 1981, a capital base of 10 percent, significantly greater than what anybody is talking about today, would be overwhelmed four times by the losses sustained by the industry as a result of the increase in interest rates during the late 1970's.

The industry today is twice as large as it was in 1981. Accordingly, I do not believe that a capital standard by itself is sufficient to solve the problem. It is one part of the solution. It is not the total solution. Once the capital is in place, it is important to make certain that systems are in effect within the institution to preserve that capital.

Senator KASSEBAUM. Do you have a level that you would suggest for capital for both the banks and the savings and loans?

Mr. FLEISCHER. My recommendation would be to determine the sensitivity of that institution's portfolio to various market changes, as an example, to a shift in the general level of interest rates to a change in the shape of the yield curve to a change in home loan prepayments to a change in loan defaults to a change in the volatility of interest rates, and obtain the assistance of actuaries who are skilled at determining what the level of safety is for the premium set. I believe that that would provide the safest way in which to operate the industry. Thus, as an example, an institution which has no credit risk and no interest rate risk and no default risk could operate on a significantly lower capital base than an institution which has significantly greater risks.

Senator **KASSEBAUM**. I would think all three would agree with that.

Mr. **RANIERI**. Except why would we need one?

Senator **KASSEBAUM**. Why would you need what?

Mr. **RANIERI**. I agree with the words. I think the logic is specious. It is true that you can blow yourself up in mortgages in the same way you can blow yourself in junk bonds. As an example, I can lend for 30 years with overnight money. That is absolutely true. It is also true that I can create an adjustable rate mortgage which is just as sure to blow me up, you know, as any commercial loan I ever invented. All I have to do is put a low enough teaser as an example, so that the thing floats but it really never gets above water.

I think the notion of a thrift, though, is that it is supposed to be a specialized housing lender and therefore understand the issues involved in mortgage lending that go beyond the very obvious one, which is the credit issue—making a good loan versus a bad loan. But if we created an entity, as an example, which only bought GNMA's, and only structured them in a totally risk-adverse way, using caps and floors and collars and all the technology which both Ernie and I understand very well, it would still require somebody else to go out and take part of the risk inherent in the mortgage?

There is a balance that has always been maintained between, as Ernie calls it, the free option extended to the home owner—OK—and the specialized lender that takes the risk of extending that free option to the home owner. If you want to take the risk away from the lender, you've got to give it back to the home owner. I mean, if you want to make a mortgage absolutely certain, then write in a prepayment penalty. Tell them, "OK, I'll lend you the mortgage for 30 years, but bloody well, you are not prepaying this thing unless you pay me 15 points." It will make it eminently more easy to solve Ernie's problem. But it has always been politically unacceptable to transfer that risk.

The issue is, how do we find a balance between financial institutions who can handle that risk and not go over the deep end with it, and how much risk you want to transfer back onto the home owner?

I think that's the function the thrift always served, you know, which is not having to throw too much of that risk back onto the home owner.

The **CHAIRMAN**. If you want to follow that, please do.

Senator **KASSEBAUM**. First, I think Mr. Fleischer has an answer to that, and I am sure his answer would be far more thoughtful than mine, and astute.

Mr. **FLEISCHER**. At Franklin Savings Association we consider our primary responsibility to take that risk away from the home owner and manage that risk appropriately. I concur wholeheartedly with Mr. Ranieri that that is the function of thrifts, and that is a function which we have performed during the past 7 or 8 years and will continue to perform. The issue, I don't think, is an issue of whether the thrift has the function or the home owner has the function. The issue is whether the thrift is responsibly managing that risk or is not responsibly answering that risk.

Senator KASSEBAUM. Can I respond to that, because you raised, Mr. Chairman, the question of whether you could manage—whether by regulation we can improve the process of examination, and so forth. Isn't that what you were asking earlier?

The CHAIRMAN. Well, partly, because you can design a system that in theory will work, but it is so complex and so arcane that you can't really police it and monitor it, and then if you've got insured deposits underneath it, you are really setting the citizens and the Government up for another fall.

Senator KASSEBAUM. But I thought Mr. Fleischer in his testimony raised two very important points which seems to me to bear on this and I think are possible, and that is that there should be a basic exam for senior thrift executives regarding interest rate risks. That seems to me to be something that makes a lot of sense and would be very important, and second, a report by the insurance fund regarding threats to the fund in the event of a change in interest rates and volatility and a change in the yield curve. Again, that may be a bit more difficult, but it seems to me very practical and important to do.

Would everybody agree on that?

Mr. RANIERI. Yes. I would—Herb, you have been silent so far, but I would tell you, Senator, that as an outsider coming in, although I have been in and around the industry for 20 years, I have to tell you that the level of sophistication that has been allowed at some of these institutions is unbelievable.

The CHAIRMAN. Unbelievably bad?

Mr. RANIERI. Bad. Yes. I mean, you know, their level of sophistication and understanding, which is what I think Ernie was alluding to, the issue beyond a good or bad loan, all of the other risks inherent in mortgage lending, as an example, has really been, in some instances, unbelievable. Even now that the Bank Board has started to move aggressively and impose requirements in terms of reporting to the Board on GAAP—if you look at the level of sophistication of those reports—I don't want to offend somebody, but you know, some of the types of risk-based analysis are unbelievable. I mean, you know, Ernie's level of expertise and, hopefully, mine is a number of levels higher than that. You can see them just starting to wean the system into that kind of sophistication and understanding. If you wanted to require that the management, since they are playing with their money and the Government's, take an exam to make sure they have a minimum level of understanding or that the level of sophistication, in terms of reporting requirements to the Board or the Bank Board would be increased, I don't see how I, for one, could argue about that.

Mr. SANDLER. You know, this is all very interesting and somewhat academic. The fact of the matter is that over a long period of time, the consistently profitable, more highly capitalized institutions are those which have remained in residential lending. Mr. Fleischer does point to the problem in the early 1980's, and that problem was, again, due to, if I may, congressional errors, because you and the regulators prevented institutions from trying to deal with rising interest rate environments by not being able to make adjustable rate mortgages. Many of us now make adjustable rate mortgages and are in a far better position, not perfect, but a far better position than we were in. So what you really have is a large list of residential lenders operating in every State represented here today of highly capitalized institutions who do the bulk of their lending on residential kinds of finance, who perform a real public service and justify the use of insured deposits, and that is getting lost in the discussion. We perform a public purpose, and that is why we have the right to insured deposits, and the interesting part of it is that this $100 billion loss did not involve residential lending. It involved use of powers that were given which have not a damn thing to do with residential lending. And that is why I find it difficult, as a residential lender, with a 20-year compound annual rate of growth and earnings of 20 percent, to try to figure out why I spent up to $50 million in paying for losses caused by people about whom I warned Congress and the regulators.

The CHAIRMAN. Senator Kassebaum, you posed a question, and I want to make one additional comment to it. It seems to me Mr. Fleischer is saying that if you go back to the 1982 period where there was this build-up and loss because of the spike in interest rates and this mismatch that lots of savings and loans have, he developed a method, with the help of Mr. Angel, to work through that. Other methods have been developed as we have come through the eighties. Mr. Ranieri is a pioneer of the mortgage-backed security. But there are now devices, as I understand it, that are available to well-run thrifts to manage and offset the interest rate risk. The variable rate mortgage is just one example. Mortgage-backed securities and the degree to which you match your interest rate requirements and offset them.

There are various market devices now for the management of interest rate risks. They are not perfect, and you can still—if things become too wild—get trapped off base and maybe, the poor operators can get trapped off base anyway, even without that. It seems to me that, in a sense, we are going to restructure the industry today. We have some devices and some innovations that are available in terms of handling the inherent interest rate risk that we did not really have to the same degree a decade ago. And you found a device, with the help of others, that helped you manage that. You helped create a device. You were in a situation where you were principally in mortgage lending where you were able, by virtue of the fact that you did that very well, to work through that period and use some of these devices. I am sure you use a variety of ways to manage that interest rate risk, so you have got the offsets in your balance sheet.

It seems to me that looking at all of that, we still have got to decide that from 1989 forward, we will have to recast this industry. One thing I hear all of you saying is, you better make very darn sure that you set it up so that it can succeed. If you craft a plan so that it can't work successfully, even if the rhetoric is good, you can send this industry right down the drain. I think I hear all of you saying that there is a very important public purpose that is being served by the industry, in the sense that fully half of the mortgage originations in this country today are still being done by the savings and loan industry. And if you take that away, who does it? Who does it in all of the towns and cities across the country where it is now being done? I just wanted to make that observation, because the question is, how do you get from the 1982 situation up to the present time and, in fact, the rest of that story is very important for us to see in terms of where we go from here.

Mr. SANDLER. Senator Riegle, just to add one point. It is not that we originate 50 percent of the residential loans, we hold 42 percent. Where are you going to put all of that if you get rid of us? Where is it going to go?

The CHAIRMAN. That is a good point, that in a sense is a second point that validates the same argument.

But let me move along to my other colleagues. Senator Pressler?

Senator PRESSLER. I don't wish to go ahead of my two senior colleagues on the committee but with their leave I will go ahead to say what I see here in the simplest form is someone who has been extremely successful at being innovative in running an S&L, whereas if that person were not so perceptive, perhaps the opposite effect would have occurred. We also have testimony on a much more conservative approach, such as the S&L's in my State have taken in operating a thrift business.

Now under the proposed legislation—I guess I will direct this to Mr. Fleischer first—if we were to pass S. 413, how would this affect people such as yourself, who I look upon as very innovative and obviously very successful. You know how to best develop this kind of business, but when someone else tries the same financial innovations with an S&L, it may well end up that the taxpayers have to pay for it.

Have I stated the proposition correctly?

Mr. FLEISCHER. I have several exceptions to take with the proposition. The first is that with respect to home loans, our portfolio is a portfolio of home loans. It is no different from the home loans that comprise Mr. Sandler's portfolio, with one exception, and that is that for many of the home loans that we have, there is no credit risk because a government agency is guaranteeing the credit. The risks, however, are identical with respect to a change in interest rates, a change in prepayments, a change in the volatility of interest rates or a change in the shape of the U-curve. What we do doesn't make money; it keeps us from losing money. We determine the points at which our equity value would go down, and we take defensive actions to make sure that that does not happen. It is not a way to make money; it is a way to make sure we don't lose money.

I think that the same computer programs that we have can easily be made available to every financial institution that is in the business of managing this risk. In order for us to continue to provide this excellent service for the American consumer, that is to take on this options risk and manage it properly, we need that technology. The knowledge base that we had at Franklin Savings Association in 1981 is no different from the knowledge base that most thrifts have today. These are skills which ordinary people can learn and do well with, and they are defensive skills. They are not skills to go out and make money. They just stop you from losing money.

BILL DOES NOT GUARANTEE SAFETY IN THE FUTURE

With respect to the bill itself, the concern that I have is that the bill does not go far enough in making certain that our financial system in the future is a very safe system. I liken it to a family that has a source of pure water but is very concerned, if everybody else drinks polluted water, the rest of the population will take ill, and there is no way for us to stop from catching that illness.

We did not make any of the loans that resulted in the large losses to the industry; however, for the past several years, we have contributed to those losses. And it seems as if——

The CHAIRMAN. You mean contributed, in terms of the premiums you are paying in to cover the losses.

Mr. FLEISCHER. That is correct.

And we will continue to have to make those payments. Accordingly, we want to make very certain that in the future, losses of this magnitude can never again recur.

Mr. SANDLER. I have a great feeling of unease—and this is not going to be directly responsive to your question. And the feeling of unease is that all of us are talking about various facets of what the restructure should look like, and after you cut through all of it, I don't believe it is really all that far apart, and we are failing to discuss what is really critical to the survival of the industry no matter how you do the restructure, and that is, that if you don't take out of the legislation the FDIC's right to increase the premium, then all this discussion is of no value, because none of us are going to be around for the long term and nobody new is going to come in to take our place, unless they are seriously mentally disturbed. [Laughter.]

The second thing we ought to be talking about is, does it make sense to take all this money out of the Federal Home Loan Bank System. If you think there is something about the thrift industry that ought to be preserved, clearly, the Home Loan Bank System is a critical feature of that, and to strip the Federal Home Loan Bank System of so much of its funds which, in turn, strips away further earnings and ability to build capital of the thrift industry, speaks to the same issue. Will you have anything at the end of this that there is to save? Isn't the real question, how much do you want to ding the industry for, not in hidden or contingent methods but determine what that contribution is going to be and make it finite, because you have the last important question, and that is, that if you have a long-term competitive imbalance on insurance premiums between banks and thrifts, we will disappear. You cannot have a competitive imbalance. And the plan preserves a substantial competitive balance with never any equality. That makes no sense. If you want to take up our premiums, I won't like it. I think it would be unwise public policy, but if you do it, do it directly and make it finite and let it come to an end, so that we can look to the future, knowing that we can compete on a level playing field with our major competitor, the commercial banks, no matter what system you end up with.

The CHAIRMAN. Senator Pressler?

Senator PRESSLER. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Wirth?

Senator **Wirth**. Thank you very much, Mr. Chairman. Again, my thanks to the three of you for being with us and helping us through this difficult issue.

I have a short question and then a longer question.

INCREMENTAL GROWTH AND CAPITAL STANDARDS

The short question goes to the issue of incremental growth and capital standards. It seems to me that, as a relatively naif in this field, if we are at this particular point with the size of an S&L now, and we say that by 1993 or 1991 or wherever you set the time, you have to have X capital standard, that there is the opportunity or the possibility that people who are here at this level are going to roll the dice again before we get to that higher capital standard. Isn't there that possibility? We are going to have a lot of gambling while the capital standard is low? Isn't that right?

Mr. **Sandler**. Not if you follow the proposal we have in our paper. The first rule I would have is that any undercapitalized company may not grow, period. Period, period, exclamation point. Second, that lending be restricted to one-to-four-family residences or mortgage-backed securities properly matched and, third, that they be watched very, very closely.

Senator **Wirth**. OK. When you say "undercapitalized," what do you mean?

Mr. **Sandler**. There are two theories of capital. The old theory used to be, let's give or take 6 percent and the new approach is the Federal Reserve recently adopted standards of risk based, which is the Basel agreement.

Senator **Wirth**. So you say they can't grow unless they meet the new higher capital standards; is that right?

Mr. **Sandler**. Absolutely.

Senator **Wirth**. Do you agree with that, Mr. Ranieri?

Mr. **Ranieri**. I think you really will see abuses if the regulator can't do something. I am not sure whether you say you can't grow at all or whether you apply some ratio to the amount they can grow as a function of where they are within the capital rules, but I don't think you give them a 2-year or a 1-year or whatever number of years free ride to grow exponentially.

Senator **Wirth**. You've got to have some kind of a transitional capital standard rule in there. Why not just say, if you grow, any growth has got to meet the new capital standard.

Mr. **Ranieri**. Yes. That's fine.

Senator **Wirth**. I mean, isn't that a perfectly reasonable thing to do?

Mr. **Sandler**. No, it is not. You want to incite companies that are inadequately capitalized to put money at risk, and if they are told they can't grow and they earn, that means capital is increasing, incidentally. You know, if you earn more money and the assets stay the same, you are, thereby, more heavily capitalized. And second, if you know you can't grow, go out and get some capital.

Senator **Wirth**. Are you and Mr. Ranieri saying anything different?

Mr. **Sandler**. Yes, sure, because if they adequately capitalize the incremental $100 million, the rest of it is still at that low capital level. I say they've got to have capital to support what they now have. You don't accomplish it under Lewie's theory.

Mr. **Ranieri**. I'm not sure that that is correct, at least the way I am thinking about it. You are going to have to sit here with a chart board and work it out.

Senator **Wirth**. The way the administration currently has it, you just can remain undercapitalized, your word, Mr. Sandler, until you get to the magic date out there; right?

Mr. **Ranieri**. We are both saying at least that. That much I am sure we are both agreeing on.

Senator **Wirth**. You are both saying at least we ought to have a transition period, and at minimum, we ought to have any new activities above which you are currently doing now, have to meet the new capital standards, and you are saying it ought to be even tougher than that; is that right, Mr. Sandler?

Mr. **Sandler**. Absolutely. The worst thing to me, after the 35 basis points and the funds are taken from the Home Loan Bank is the undercapitalized competitor. It drives us crazy.

Mr. **Ranieri**. Herb, I am certainly not saying that you take any new capital and ascribe it all to just the growth and not have to increase the base. That is why I am saying that I am not sure that we are really very far apart. If you are saying that I think you should leave 3 percent in a $1 billion institution, and that every dollar of capital you only ascribe to your growth, I am certainly not suggesting anything like that.

Senator **Wirth**. OK. Well maybe we might get your—you have been very specific in your testimony, Mr. Sandler, as to how you think this transition ought to work, and maybe Lewis, you might have a chance to look at Mr. Sandler's proposal. Why don't we do it that way? Maybe you could look at that. He's got a tough transition capital standard.

Mr. **Ranieri**. The only thing wrong with it, because I would love to use it, is whether it is completely practical for everybody.

Senator **Wirth**. Maybe you could look at it.

Let me go to the 60 percent, 40 percent issue. Mr. Fleischer, did you have any reaction? I'm sorry.

Mr. **Fleischer**. I agree completely with Mr. Sandler's position on this issue. I do want to raise a related point, however, and that relates to the goodwill issue. For this purpose, goodwill should have a zero value from day one. To the extent that unfairness has occurred, that unfairness should be properly rectified at this time. The proposal that Empire has made, I think, is very meritorious, but I don't think it makes any sense to say that they operate without real capital.

Senator **Wirth**. Got it. Got it. Let me jump in the time remaining to me to a broader issue, and that is the 60–40 powers issue. The argument is made that those savings and loans that are in home loans or home mortgages alone can't make enough money to service those home mortgages and consistently they have to have the income coming in from the additional more speculative, higher return investment. We all agree that that is what the thesis is. The question then becomes—isn't that right?

Mr. **Ranieri**. Yes.

Senator Wirth. The question then becomes, what is in that 40 percent? Should the Federal Government be in the business of defining this all narrowly to say that you can only be, 9 percent in Y, 11 percent in Z? Should we be doing that, or should there be some other criteria for defining what that whole pot of 40 percent is, other than capital standards?

It seems to me, Mr. Chairman, that that is very fundamental to this whole question of nontraditional S&L's.

The Chairman. Well, you got three deep breaths, because it is an important question, and I think it is important that we hear from you all.

60-40 FEDERAL-STATE POWERS

Mr. Sandler. Obviously, in the paper we have submitted, we have pretty strong views. I look at the record of the residential lenders and they haven't caused you guys any problems. The first thing we propose is that, first of all, we go from 60 to 80 percent, although we don't feel that strongly about that, but we feel what the other assets ought to be in are things like consumer loans, education loans, commercial real estate loans, land loans, nonresidential construction loans, but except for consumer and education, none of those other categories can exceed 10 percent. I also provide in our proposal, incidentally, a shifting back and forth between thrifts and bank charters. Since we have the same capital requirements in the future, since we have the same regulatory structure and essentially the same regulator, why can't we go back and forth? And if somebody feels impacted by the high residential requirement which confers two benefits, a small bad debt deduction and access to the Federal Home Loan Bank credit mechanism, if you feel that you are constrained, become a bank. You meet all the bank standards. And have their broader authority. What is wrong with that?

Those are the appropriate historical uses when you are in the business of being an intermediary which has fiduciary responsibilities, and I don't understand the other powers. If you want to give the other powers to banks, and I like them better than residential requirements for thrifts, I will switch to being a bank, I will drop my residential lending, and I will do these other activities, but I lose access to the Federal Home Loan Bank System and the bad debt deduction.

What is so horrendous about that? What is wrong with that proposal? Where is the weakness in it?

Senator Wirth. Mr. Ranieri?

Mr. Ranieri. I have an answer to Herb's, you know, sort of begging the question, "what's the weakness in it." I agree with the categories Herb generally said. Generally, as I said earlier when I was asked the question where I am most comfortable seeing that other 40 percent allocated, is in the things that make the most sense under what the charter was supposed to be in the first place. But I always have this reluctance to say that I know what is best for everybody in every jurisdiction. What I have found is, or what I believe to be the weakness in the system is that thrift's weren't using their own money. Also, there was this great discrepancy between

State charter and Federal charter which made it one more level of complexity for the local PSA.

If in the first instance there is adequate capital and they are playing with their own money, I guess I still have less of a concern with what they do with it within reason. But I told you before, if somebody said they were going to put 40 percent of their portfolio in junk bonds, I just have a hard time—not that I really think junk bonds are terrible, because I don't. I just have a hard time rationalizing that under a thrift charter. I just don't understand necessarily how it fits, but I really do believe a person should have the ability to make reasonable choices. And I guess the question is, how do you define "reasonable" Herb, within the basket. And it is easy, Herb, in California, where the housing markets have been so robust, to blithely say, "Let's up the QTL test." I think it is much more different in markets like ours, as an example, where there is not a lot of housing going on, and where we would be forced to buy all of our mortgages from somebody else. And you have to remember, as an example, in ARM's, they make them at 250, but they sell them at 125. I mean, you know, I'd like to be on the other side of that equation. Maybe, if the West Coast closed down economically and Houston picks up, we will be on the opposite side.

I think that is where the nub is. You know, housing is still a very regional type process, and although I just emotionally don't have a terrible problem with the QTL test going up, I am not sure that that is the way to fix the problem, and I don't know if I am answering directly what it was you were asking. I really do think you need the ability to choose within reason within that basket, and I really think the solution is, in fact, first capital. But I would also tell you, if somebody proposed some reregulation to make sure that the selections within the basket were within reason, and that you didn't have somebody putting 50 percent or 40 percent of his capital in direct investments and joint ventures that went out and built racetracks. I wouldn't have a problem with that, because I would have a problem if they did that.

Mr. SANDLER. Could I ask Lewie just one question, Mr. Chairman?

Senator WIRTH. My time has expired, Mr. Chairman.

The CHAIRMAN. Well, if we can do it very quickly. Then I want to go to Senator Bond.

Mr. SANDLER. I just wanted to know, even if you are in a regional area where housing is weak, if you meet the capital standards which Lewie does and others will of a commercial bank, and you can have the powers of a commercial bank, then what's the problem?

Mr. RANIERI. Herb, I don't know if there is a problem. I obviously had the capital if I wanted to buy a commercial bank instead of a thrift, but my background is housing. I like housing. That is why I bought a thrift. [Laughter.]

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, in Mr. Ranieri's testimony, he raised a question as it related to the $300 million annual draw from the Bank Board System, and I understand he expressed a concern that this draw will impede the System's ability to support home mortgage lending.

No. 1, I would ask him to expand upon that. No. 2, I would ask our other panelists if they might comment. And why, Lew, do you feel that that might take place?

CONCERN OVER THE $300 MILLION ANNUAL DRAW FROM BANK BOARD SYSTEM

Mr. RANIERI. Well, in the first instance, I think what you have to keep in mind is that there is a very big difference in the funding process for thrifts versus commercial banks. Very few thrifts, in fact, I think a handful of them, less than six—only one of which is represented in this room—are, investment grade. So very few thrifts can borrow in the markets like commercial banks. The balance of the funding for thrifts comes through the Home Loan Bank System. It substitutes for the open market borrowing that commercial banks do. Since I really believe that the Home Loan Bank System will, in fact, shrink as the thrift system shrinks, I think that the $300 million number which was supposedly 20 percent of earnings may, in fact, wind up being a much higher percentage of earnings.

Every time you weaken the Home Loan Bank System, in my mind, two things occur. One, you raise their cost of borrowings. You have seen that already, and that gets passed back to the thrift and that inevitably gets passed back to the home owners in terms of the rate he pays.

The second is that at some point, I talked to most of the bank presidents about this, and three of them told me yesterday that they have calculated, given their views of what is going to happen, that that $300 million will eventually take the system down. In other words, it will make the system so marginally——

Senator D'AMATO. May I ask, is there also a concern expressed that there are a number of, for example, I think 40 percent of those institutions in New York are FDIC insured, and that they may withdraw, if the dividend is reduced, the dividend now being about 9 percent, and if that is the case, will their withdrawal further weaken the Bank Board?

Mr. RANIERI. There are two jurisdictions in which that becomes a very severe problem. You see, thrifts have no choice. They have to be there. The FDIC-insured savings banks which are very large here on the East and some on the West Coast, in fact, can withdraw. They will withdraw on one of two bases. First, the borrowing cost becomes unattractive. The thrifts still have to be there. They have no choice. They've got take the money at whatever the cost is. The FDIC-insured savings banks, in fact, can find other sources, so they would withdraw, based on that. I think what also happens is that if they think the value of the stock they have in there is going to decline exponentially, they are not going to sit there and knowingly take that kind of loss. They will withdraw from the system.

I think people have overlooked how critical the Home Loan Bank System is in the housing funding role, and that when you tinker with the Bank System, it is almost worst than tinkering with the thrifts, because the thrifts are individual entities, and they sort of bounce up and down and sideways, but the Home Loan Banks, you know, are sort of like the behemoths, and when you tinker with the 800-pound gorilla, it gets real dangerous.

Mr. SANDLER. Senator D'Amato, that was a particularly astute question. It has two effects. The first thing that is going to happen, first we will take the—there were two takings from the Federal Home Loan Bank System. The first one is $2 billion of the current surplus, and the second is a $300 million a year. Assuming favorable accounting treatment to the Federal Home Loan Banks, that will reduce dividends nationwide by about one-half. That will reduce the earnings of every institution, reduce their ability to make their capital and reduce their ability to make loans.

As a matter of fact, the 1988 dividends were approximately 25 percent of the total earnings of the institution. $1.2 billion of whatever the number is. It is approximately 25 percent, a major, major hit. The administration doesn't seem to focus on that particular problem.

But this second level is a very sophisticated level, and that is, what about the strength of the Federal Home Loan Bank System? It is currently a AAA-rated entity, and it enjoys very favorable treatment in the capital markets. What will happen, in all likelihood, both as a result of this taking and as a result of some current requirements to the Home Loan Bank System to make more risky loans than usual, is their costs of consolidated obligations will increase. That will then be passed along to the borrowing members who, in turn, will pass that along to the home buyers. So you are going to then get another hit to the home buyers. You ought to understand that the Federal Home Loan Banks have advanced $155 billion to savings and loans, who have been able to lend that to home owners. That means an enormous impact on the cost of borrowing. And nobody, nobody is talking about that, sir.

Senator D'AMATO. Mr. Fleischer.

Mr. FLEISCHER. I concur with all the comments that Mr. Ranieri and Mr. Sandler made with respect to this issue. I want to point out, in addition to that, that industry members, such as Franklin Savings, are looking very seriously at whether or not it makes economic sense to continue seeking additional advances from the Federal Home Loan Banks, since with each additional advance, additional stock must be purchased, and the yield on that stock would significantly impact the institution's earnings and, therefore, the cost of those funds.

Currently, we have over $2 billion advances outstanding from the Topeka Federal Home Loan Bank. We have no applications pending at the present time and have not had since this proposal was announced.

Senator D'AMATO. I was wondering, is staff listening?

Mr. SANDLER. There was one thing.

Senator D'AMATO. No, just a minute, Mr. Sandler. Is staff listening.

Senator CRANSTON. Could I just say for the benefit of the members that there is a rollcall on the Cheney nomination, I believe, starting now, a 15-minute rollcall.

Senator D'AMATO. I would suggest, if I might, and my time has expired, that you really undertake to do something to educate the administration, that you suggest, if indeed Mr. Ranieri's position as a percentage as opposed to a definite figure would be better or if there would be another alternative that you could come up with, as opposed to something that I believe that very few of the members are cognizant of and view this simply as a way to plug in numbers without having to go to the taxpayer—which in the long run will absolutely turn this situation into a further calamity and will exacerbate the problem and not help it.

Right now, I don't think we are focusing in on this at all.

Senator **Bond**. Thank you.

Senator **Wirth** [presiding]. Without objection. Senator Kassebaum?

Senator **Kassebaum**. I have already asked my questions. I would just like to say in closing, I think it has been a most informative panel, much food for thought, and we could have gone two or three more rounds as far as I am concerned.

Senator **Wirth**. Well, Senator Riegle has gone over to vote and is coming right back.

Senator **Kassebaum**. And you're going to keep it going?

Senator **Wirth**. I am going to keep it going till he gets back. So if you want to go over and vote and come back.

Senator **Kassebaum**. Well, I can't come back, but is it my turn?

Senator **Wirth**. Please go ahead. It is now. [Laughter.]

Senator **Kassebaum**. Well, I would just like to ask—because I think Senator D'Amato's question was obviously one that was very thought-provoking and in which I guess all three of you would concur. Mr. Fleischer, in your testimony, you said that you didn't think there was really the need for a thrift industry. Am I correct in that?

NO NEED FOR A THRIFT INDUSTRY

Mr. **Fleischer**. Yes, Senator, you are. There is not a need for a thrift industry; there is a need for the services provided by the thrift industry.

Senator **Kassebaum**. That's right. And I believe, if I am correct, and I think your idea on the two banks or financial structure, I should say, is a very innovative one. I am not sure we are ready for that yet, but obviously, I think these are things we need to think about. But when you said that banks and thrifts really should essentially have identical powers and charters, the question we always get then is, well, would there be—would they then be doing home mortgages? Would there be the interest in really undertaking something that Mr. Sandler has said is a basic responsibility of the thrifts?

Mr. **Fleischer**. The interest which the thrift industry has had in home lending, I believe, would be carried on by those firms, whether they would be called banks, thrifts or financial intermediaries, because that is the area in which each has human capital. As Mr. Ranieri commented earlier, he clearly had the capital to buy either a thrift or a bank. He chose to buy a thrift, because what he wanted to do, because of his skills, was to concentrate in housing. If the category, thrift industry, would be abolished, I believe that the industry members would be far more effective in supporting housing than they would be under the administration's bill where they are asked not only to support housing but to bear risks and charges, which banks currently are not being asked to bear.

It is an unfair playing field and, therefore, I think it is destined to failure.

Senator KASSEBAUM. But if the playing field were level—and let's go back again to if there were no distinctions—do you think the resources would be there that would be committed to residential lending?

Mr. FLEISCHER. I personally do because I believe that the income is there in residential lending. To the extent that that income is not, what would occur in the marketplace is what usually occurs. The less efficient suppliers of service would withdraw from the market, leaving sufficient income for the remaining providers of that service.

Senator KASSEBAUM. But is not your own residential lending low at Franklin Savings?

Mr. FLEISCHER. Our own residential lending is significantly more today than it was in 1981 when we were a traditional thrift. It is low only in relationship to total assets. It is not low in relationship to the participation in our own markets.

Senator KASSEBAUM. Mr. Ranieri?

Mr. RANIERI. Senator, I have to take great exception. I disagree completely. I honestly believe that without a QTL test—which is what basically says to a thrift, you're in housing—that the end byproduct would be no support for housing. I mean, I guess the only way I know how to say this is that a mortgage, because of its nature—not only the free option extended to the home owner, but the susceptibility of the individual home owner to macroeconomic circumstances outside of his control and all sorts of other issues—is a uniquely terrible investment. I mean, it is one of the silly investments you can think of in comparison to commercial mortgages or, corporate loans or whatever, where you are allowed to sit in there and negotiate individual terms and conditions and protections, and all sorts of things.

I think the reason that thrifts have become specialists to the degree they are good at it is, they are forced to stay in there, they have nothing else to do, and they have to stay in there for that portion of their portfolio in both the good times when mortgages are, in fact, attractive, as well as the bad times, when they are uniquely not attractive. Without that QTL test, which is what defines a thrift, there are points where, if you are going to do what's ever in your own parochial best interest, you are going to have a hard time finding a guy who wants to lend on a mortgage. I really believe that.

Senator WIRTH. Senator Kassebaum, we are going to have to break this off, so you and I can go over and record our votes. I know that Senator Riegle is coming back, and I hope that we continue long enough. I had a couple other things I wanted to talk with you about before we break, so maybe we could take a momentary recess. Senator Riegle will be right back. Thank you very much.

Senator KASSEBAUM. Thank you very much.

[Recess.]

The CHAIRMAN. The committee is now back into session, and let me invite our witnesses to return. When we have a vote that interrupts the proceedings it is always a little awkward for everyone, but I am sure Mr. Ranieri will be back in a moment.

I think this has been one of our most important days of hearings, and we are not finished as yet. I want to review a couple things in the time that we have left. The vote that we are leaving for, if it has not been announced, was the vote to confirm Mr. Cheney as Secretary of Defense. So, that was the purpose of our interruption.

I want to ask each of you, if we take the administration plan as is, is there an element or are there elements of that plan that, in effect, will prevent the success of the industry recovering and going forward on its own in the future? In other words, are there defects in the plan that absolutely have to be dealt with in your view if the plan is to work successfully? And if so, what are they?

Some of these things have come up during the course of the day, but I want to go right to the point. I am not saying defects to try to apply a normative judgmental word, but I want to make sure that we have identified aspects of the plan, however well-intended, that may have a perverse consequence and that could end up causing the system to fail.

Mr. Ranieri, let me start with you and then I will come down the table.

PROBLEMS TO BE DEALT WITH IN THE PLAN

Mr. RANIERI. Well, I think in the context that you raised, I think that the current structure of assessments against the Home Loan Bank System, if they were enacted exactly as they are now, will eventually force that system to cease functioning at some point, and I think most of the bank presidents feel that way, and you can't have thrifts, or, in fact, a current system of housing if the Home Loan Bank System doesn't function. OK? So I just think that is a time bomb that has been set up that will inevitably go off under the current structure.

I think the second problem, although it is much more difficult to prove, is this whole motion of the open-ended assessment. I told you, charge as much as you think you can get away with, but the open-ended nature of the assessment will keep outside capital from coming in. Since I think the reality is that the internal capital accumulation is, by definition, going to be small because of the assessment, you need that outside capital. I am less concerned about it from the context of somebody saying, well, you can't raise my premiums. I am just concerned about it from what it represents as stopping outside capital from coming into the industry.

The CHAIRMAN. Now on that point, on the open-ended assessment, are you saying, that you have to have a point in time down the road where banks and S&L's are on the same footing, or are you saying that there is an absolute level above which would threaten to topple the system?

Mr. RANIERI. Actually, both. The more serious is the belief of the world in general that these institutions will be allowed, if they are profitable, to generate earnings that can be paid to stockholders, OK. So if it looks like what they have done has been trapped in a corral where their earnings are going to be continually bled off, nobody will put money in. So I mean, that is the most critical portion of it.

The CHAIRMAN. Yes.

Mr. RANIERI. And I say delegate that role to the Congress—I am not saying put in a bill that you will never raise premiums. I am saying, leave that to the Congress, that if 5 years from now they have got to do it, so they have got to do it. I mean, they can never take that ability from themselves anyway. But don't leave it to an administrator to make that decision. The second, obviously, is ——

The CHAIRMAN. Let me just comment on that point, and then we will come to the second. The counterargument to that is that you want to depoliticize the process, and in effect, you want to have a regulator who, if it is a competent regulator, would be more insulated from political pressure, would be much more mindful of the numbers, would apply a kind of independent financial integrity to the work, and would, in fact, be capable of a better administrative judgment than, say, the Congress coming back and trying to make that rather sophisticated financial judgment.

Mr. RANIERI. My response to that would be twofold. I think since you are tinkering with the housing funding process that the Congress cannot, in good conscience, delegate that responsibility. You are obviously talking about losses here in the billions of dollars and people with reasonable degrees of experience are saying that this, in fact, will increase the losses. But again, for the Congress to sort of take the easy way out and say, "Well, good, I'll delegate it to somebody else and the burden of it will be his," is just not right. I mean, that is why you're the Congress. I mean, he is only an administrator. He is one human. Regardless of how good, bad or indifferent you are. You're supposed to be the wise men. That is why there are a lot of you instead of one, and for you to delegate that responsibility to somebody else and take the burden off your own backs, I just don't think is really fair to the public.

The CHAIRMAN. I think that is a good rejoinder.

Now go to the second part of the open-ended assessment question.

Mr. RANIERI. The second part is, inevitably, you are going to have to rationalize the whole deposit system. If thrifts always pay a premium well in excess of commercial banks, if that is going to go on in perpetuity, eventually you have to believe that they will cease to operate as competitive forces. I think that is much less immediate than some other people, but I think, it is inevitable. If you say for the next 15 years that the spread between a thrift and a commercial bank is going to be 10 basis points of the deposit insurance, I think inevitably it becomes crushing. I don't think it happens as quickly as everybody else thinks, but I am certain that inevitably commercial banks decide that they want to get into housing more than they have decided over the last 20 years, and if they are armed with an advantage where they can do exactly the same thing only pay less, sooner or later, they will eat your lunch.

The problem with that is that the thrifts don't die quietly. You can't arrange seemly funerals. When they die, they create big holes in the ground that have to be filled up with the taxpayers' money. So that is my rejoinder to that particular issue.

The CHAIRMAN. Yes. I want to move down the table, but I want you to think further if there is anything else that is a potentially fatal defect in the plan that needs to be identified. Again, I want to make sure that we're working off the base of the administration plan as presented.

So, Mr. Fleischer, what is there in that plan, if anything, that you would see as something that has to be altered in some measure, if we are going to have a reasonable chance of the recovery plan to work?

Mr. FLEISCHER. The plan first has to mandate better risk management than exists today within the system. In the absence of that, the deposit insurance premiums for taxpayer contributions will have to be made in the future. Those expenditures, just as the expenditures over the past several years, will have to be made from the surviving industry members, who will not be able to afford those payments.

The CHAIRMAN. Now can you tighten that down a little bit? In terms of how the administration bill would propose to handle risk management, is there a part of the bill at which you can point to indicate that you think that that part is drawn improperly, or are you talking about adding an entirely new element that is not in the plan at all?

RISK MANAGEMENT

Mr. FLEISCHER. An entirely new element, Senator. The only way in which the bill addresses it is capital. I think we can look back to the 1970 era when the industry was a very simple industry and half its current size, and recognize the loss that was sustained in the absence of proper risk management.

The CHAIRMAN. OK. If I understand you right, you see what is potentially a fatal defect in the administration's plan, but the defect is an omission of a part that needs to be there. An omission that deals much more directly and strongly with the risk management question.

Am I hearing you correctly?

Mr. FLEISCHER. You are.

The CHAIRMAN. Now is there anything else that is either in the bill or not in the bill that, in effect, would be, in your view, a fatal defect?

Mr. FLEISCHER. A second fatal defect is that the thrift industry is being asked to compete on a nonlevel playing field for capital. Capital will go to whoever has a comparative market advantage. The thrift industry does not have equality in this bill. I can think of no moral reason for imposing an additional chore on the surviving thrifts which not only have not caused the problem but have also, up to this time, contributed very substantially to paying for the problem; that's right.

The CHAIRMAN. So is there anything else that you want to identify in that category that, if it isn't changed, may well sink the whole package at some point?

Mr. FLEISCHER. The third relates to goodwill. If we really believe that banks can operate without real capital, banks which did not participate in regulatory-encouraged mergers could operate safely without real capital. The fiction of the past several years has to be ended. Those institutions which participated in those transactions should be fairly compensated, but we should only have industry members who are properly capitalized.

The **Chairman**. Now, again, I am going to say the same thing I said to Mr. Ranieri, if you think of something else that falls into this category, I want to come back—or did you want to comment on something you just said.

Mr. **Ranieri**. I had one other.

The **Chairman**. Well, let's hear yours, and then we will go to Mr. Sandler.

HOUSING IS AN OVERADVANTAGED PORTION OF THE ECONOMY

Mr. **Ranieri**. There is an embedded fatal flaw although it is much more difficult for me to prove it to you, and that is the extent that the Home Loan Bank System basically reports to the Treasury for everything. I told you I think it feasible that it report for supervision. But there is a flaw to the extent it reports to Treasury, so that, in fact, the thrift industry and the Home Loan Bank System are at the political discretion of the Treasury. In 8 years of dealing with this committee in three bills, the administration has over and over testified that they believe housing is an overadvantaged portion of the economy. And to the extent that you deliver the ability to control the flow of funds into housing, to the Treasury, I don't know why the guys who have already said on three separate occasions it was overadvantaged, won't use that advantage to lessen the amount of flow of funds into housing.

You know, you are sort of saying that particular leopard is going to change its spots. And I think if that is to be, if the flow of funds into housing is going to be changed, that that is a congressional decision not a Treasury decision, and so I think that the ability to make the political decision about how the Home Loan Bank operates, in terms of the flow of funds and how the thrift industry operates in terms of its funds into housing, should reside in the Congress for very obvious reasons.

The **Chairman**. Yes. I want to come back to that. Mr. Sandler.

Mr. **Sandler**. Staying within the direct confines of your question, there are three clear categories that are totally perverse and accomplish the opposite of what is intended.

The **Chairman**. And if not changed, in your view, would sink the system in the future.

Mr. **Sandler**. Without question. I am leaving out things that I feel strongly about but don't come within the confines of your specific question.

The **Chairman**. Very good.

Mr. **Sandler**. The first is the right to increase the premium by the FDIC, whether to 35 basis points or higher. It is clearly counterproductive. It inhibits that which is required, both by the administration and by common sense, namely, the ability, necessity, requirement to increase capital. It totally prevents it. No new capital will come into an industry that will then be underearning. It is hard to know where they were coming from.

The second is the Federal Home Loan Bank System, and there are two aspects to it. The first is the taking from the system. I can tell you that no one in Treasury, and I will underline the words, no one in Treasury has made any analysis of the impact of that on the system. I forgot to mention earlier in response to Senator D'Amato's question, of the $15 billion in capital, of which $12 billion is contributed by the members, approximately $3.5 to $4 billion of that is discretionary and can be pulled out. That means that when the dividend goes to 5 percent, significantly below market or zero, which is very possible, all of that or most of that will be pulled out, the cost of consolidated obligations will go significantly higher and you will destroy one of the best mechanisms fostering homeownership. That's crazy.

Second, to put the Federal Home Loan Bank System, a system that Congress fostered in order to serve economical home finance, to put that under the Treasury, whose historical bias against that is so well-known, the bowels of the Treasury shudder when they think of it and to give them the right to control the Federal Home Loan Bank System is an announcement that you are either extraordinarily naive, or you are extraordinarily cynical, and you know what is going to happen, and that is your real objective, which is to get rid of the Federal Home Loan Bank System.

The third area is the area of perpetuating an inequality of premiums. I don't mean stated premiums; I mean all-in-cost premiums, the obvious ones, the hidden ones, they've got to be the same as banks, because, as Mr. Fleischer aptly points out, if they are unequal, there is no question the banks will eat our lunch and we will perform less of a function in the homeownership system.

On an overview basis, you should be concerned with the complexity, and you should be concerned with the rush. We all want to hurry to close the institutions. I get a little nervous when I look over at Treasury and I see a whole bunch of new people who never dealt with a savings and loan in their life, and who have not done the analysis. I am appalled they haven't done the work on the impact of the total Home Loan Bank System, even though they make significant recommendations in that area, and it harkens me back to the deregulatory process of 1981 and 1982, in which Congress ran ahead, helter-skelter, bungled the job, and we are now meeting today and reaping what we sowed back then.

The CHAIRMAN. You were nodding in the affirmative quite aggressively there, Mr. Ranieri.

Mr. RANIERI. That last statement. I feel very strongly about the last statement. You have to applaud the President for moving so quickly. The danger of moving so quickly is there is a lot less backup data for some of these things than normally you would like, given the magnitude of the implications of some of these things. Herb and I feel, you know, although we very rarely agree on almost anything, we feel very strongly on what happened in 1981 with Garn-St Germain, because there was at that point, if you remember, a great deal of discussion over how quickly these new powers should have been imposed, and what would have been the result. I remember one discussion, here, in fact, where people were complaining that there was nobody in the supervisory system who knew how to underwrite a commercial loan. In fact, there was no commercial loan handbook in the supervisory system for many, many months after the bill was enacted. So that we sort of threw the powers on an unsuspecting regulatory system and said, "Here, you figure out what to do," although the warning was clear then what would happen.

The CHAIRMAN. Let me ask each of you this, and I would like a brief answer, but it goes to this point:

We obviously want to do this right. This committee feels this way; I sure feel that way. Yet, we hear that the losses are mounting, and there is a lot of uncertainty out there. You've got the competence issues. You've got the need to craft a solution as quickly as we can. We don't want to hurry and enact a plan that is going to blow up down the line. That obviously would be a huge mistake.

I am asking each of you the question as to how long you think we have. Where is the crossover point on that one? How long can we take from today in order to try to be as sure as we can that we've got it right before we've taken so long that we, in effect, would be working against ourselves.

What is your view on that, Mr. Ranieri?

HOW MUCH TIME DO WE HAVE?

Mr. RANIERI. I will give you two answers. If you assume you did nothing, you made no other moves, which I don't suggest. As an example, if you assume that no more firmer control is placed over the funding process of some of these insolvent institutions and that they are allowed to pay anything they want. So I mean, if you say, OK, let's leave everything the way it is now, how long can you wait? I honestly don't think you have that much longer, because you are destroying the franchise value.

The CHAIRMAN. How much is "not that much longer"?

Mr. RANIERI. 3 months.

The CHAIRMAN. 3 months?

Mr. RANIERI. Yes. If you were to take some curative action which: (1) bolsters public confidence, and (2) curtails the losses, in the meantime, I think you do have much—you know, you could have more time. That is why I was reluctant to give you an answer——

The CHAIRMAN. No, I understand. We are asking for a judgment. It is very difficult to make the judgment, because on the one hand we want to hurry and we want to do it right now. On the other hand, if we don't do it right, we can set ourselves up, not for a $100 billion loss but a $200 or $300 billion loss. I don't want my name or this committee associated with that kind of a work product.

So in any event, you think, without any changes, we probably have 90 days to get this job right, but you are not urging that we take the full 90 days to do it.

Mr. RANIERI. No. No, not at all. The sooner the better.

The CHAIRMAN. Yes. Mr. Fleischer, what is your comment on that?

Mr. FLEISCHER. I suggest that you proceed immediately with authorization to the FDIC to transfer the deposit bases of the failed institutions to other institutions or to pay off the depositors, whichever they believe is the more economical now, and get that done before the bill is fully considered. All of the other provisions can wait and should be studied carefully.

The **Chairman**. Well, here is the problem with that. I understand where you are coming from and that is an attractive idea. However, I think the general view is that if you start feeding money into the problem without at the same time linking it to the fundamental changes in reforms, there is a great chance that you will spend the money and not get the reforms. There is a desire to keep these things in tandem, so that you get both things in place at the same time.

Now, how do you react to that?

Mr. **Fleischer**. I believe that is an expensive luxury, one that we can ill-afford, because every day that passes increases that expense. I believe that Congress has the self-discipline to assure that the other reforms are passed, and with respect to the deposit transfers, could mandate those be transferred only to institutions that do meet the new risk-based capital regulations after giving effect to those transfers.

The **Chairman**. You wanted to add something, Mr. Ranieri, before I go to Mr. Sandler?

Mr. **Ranieri**. To what Ernie just said, and that is, or at the very least, fund these guys internally, so that you don't continue to exponentially increase the losses.

The **Chairman**. I think there is probably a way to do that. Creative administration that was losing money because it was in a situation where it couldn't turn off the faucet, ought to be able to find a way, I would think, to do that in the interim until we get this package in place. Smart minds have to work on that to come up with how it is done.

Mr. **Sandler**. I can give you one simple answer in terms of the funding issue. Right now the administration has a plan which has been in the papers, where they are causing the Federal Home Loan Bank System and others to be in a position to fund withdrawals. If you are going to do this to the Federal Home Loan Bank System, which has dangers, give the Federal Home Loan Bank System full faith and credit in connection with the moneys they advance, you will be able then to deal with the funding problem of these institutions while you are working on the legislation. That will quiet everybody down, and it will all be quiescent at that point. You can work at your leisure, which I don't think should be very long. I don't see any difficulty in doing this in 60 to 90 days, if the administration will be cooperative rather than say this is our plan and you can't touch any part of it, which is frankly what they are telling the various groups that meet with them. They are working within their little game of taxes, budget, don't touch the banks here, play this game here, and it is all in a little box, and it is a silly little box, because what we ought to be doing is focusing on solving the problem.

I still don't understand why somebody doesn't look at the GAO and CBO proposals, because they make such eminent sense, and they are the least-cost solution, and it wouldn't take very long for you to move forward with that, together with a restructuring plan and accomplish what you want. There are plenty of us who would be willing to provide any help or assistance you need.

S&L CRISIS HAS BEEN BUILDING FOR A NUMBER OF YEARS

The CHAIRMAN. Well, I just want to say one thing before yielding to Senator Cranston. As the Treasury and the administration has developed this plan, we've taken it, we've introduced it, and we've worked on it very intensively. We've put everything else aside in this committee. We are completing our hearing phase today—18 days of hearings. All of which, I think, were needed. So we are moving ahead as fast as we can. But I have to say, looking back, that the administration, while it is new, is old as well. It was a Reagan-Bush administration, and it is now the Bush administration. We heard almost nothing about this problem last year. In fact, this committee tried very hard to force this issue up onto the table so that we could get started at that time.

All the efforts of that administration were to minimize the problem and were to say, you know, let's not really get into this now; we will do it at sometime in the future. A lot of this was soft-pedaled. In fact, I never, to my memory, can remember a single time I ever heard President Reagan mention the savings and loan problem. Not once. And when that administration went out the door, we find that $100 billion is missing in the savings and loan system. It is a little breathtaking, I think, and I believe the public finds it that way.

That doesn't subtract from the fact of a real necessity for immediate action, within the bounds of doing it competently and sensibly, so that the action we take will work.

My intention, and I think it is generally shared on this committee is to do this job just as quickly as we can, but to do it with a genuine belief that what we have done will work.

I am not going to vote for something that I don't think is going to work. If the best we can get is something that has the appearance of being successful, but it won't work, it may go through here, but it is not something for which I want to vote. It is a very difficult situation, because we are talking about as complex a problem as I think we have ever had to solve before.

During the 100th Congress, I was the chairman of the Science and Space Subcommittee. I took over that committee shortly after the Challenger explosion, and that was in a different form, a catastrophic system failure, something we had never had before. We lost the Space Shuttle; we lost the astronauts, and it took us in that case virtually 2 years of minute detailed effort to figure out what caused that system failure, but we didn't just stop there. We took that time as the occasion to ask, what else could have happened that didn't happen that also could have caused a catastrophic system failure? That's what we want to do now with the S&L's. We've lost $100 billion and perhaps far more than that is in redesigning the system. But we want to make sure that it is not susceptible to the causes that took it down the last time, and we want to make sure we've been smart enough to think a little more broadly to try and design in changes and safeguards so they can't be brought down in the future by some other perverse set of causes.

That is exactly what we did in the Challenger situation, as wisely we should have. I am not trying to make a direct one-for-one comparison. It is obviously an analogy. But it took us a long time.

The Chrysler loan guarantees were an infinitesimal fraction of this, slightly over $1 billion. In that situation everything guaranteed by assets, and we knew we couldn't lose a dime. It worked out well; we made a lot of money. It took us a full year to work that package out. This is literally a hundred times that size and unprecedented in its complexity. And I am sensitive to the idea of doing this quickly, but I am not persuaded that if doing it quickly means doing it so that it is going to blow up again, that doing it quickly buys us anything other than a future disaster.

You have been very helpful in your testimony today, and we are going to weigh what you have said very carefully. I know my colleagues who are not present feel that way as well.

You wanted to make one comment, and I am going to excuse myself and turn the gavel over to Senator Cranston.

Mr. FLEISCHER. With respect to the concern of funding the existing deposit liabilities of those institutions which are under the conservatorship of the FDIC, while a full faith and credit funding of that might save 100 basis points, another 200 basis points is being spent today simply keeping the institutions open in general overhead expense, so that unless these deposits are transferred and the institutions literally closed down immediately, that expense will continue and will be a part of the ultimate cost.

The CHAIRMAN. I think that is an important point.

I want to thank all of you, and I want to yield now to Senator Cranston. I must leave to attend a funeral service.

Senator CRANSTON [presiding]. Thank you very much, Don. I won't detain you much longer, but I have a few things I want to ask.

What is your view on letting banks in communities where the bank meets the QTL test to have access to the Federal Home Loan Bank System?

Mr. FLEISCHER. I am in favor of that very strongly, because I believe that we should do everything that we can possibly do to encourage participation in the housing market. I urge a level playing field for thrifts. I also urge a level playing field for banks.

Mr. SANDLER. We make a specific recommendation on that. We believe that it should be opened for banks, and they can even have a lower QTL, but they would have a lower borrowing level. The same concept of level playing field works both ways.

Senator CRANSTON. Lew, in your testimony, page 8, you say "The proposed capital levels of S. 413 are correct, but the plan should generally extend the phase-in of these requirements through June 1993."

If we extend the phase-in of new capital requirements, do you think we should put firm and pretty precise or perhaps very precise benchmarks to the new levels in the law itself, so we don't get into another forbearance situation?

Mr. RANIERI. Absolutely. I think the thing that the President's proposal does do, as I said earlier, which I think was the most important issue, is to require real capital. Otherwise you can't play. And to resolve the accounting issue. We have as an example, forbearances, and we are one of the institutions with forbearances, because we bought a Texas institution. I think you have to set capital standards and say, sorry, guys, everybody is going to meet the capital standards. And you know, we are not going to have 15 guys playing by 23 different sets of rules. I feel very strongly—I guess that's why I also think you pick a date and a phase-in period that is realistic, because I don't think you should have exceptions to the rule. I really feel very strongly about that.

Senator **Wirth**. Mr. Chairman, if I might just briefly.

Senator **Cranston**. Sure.

Senator **Wirth**. I wanted to come back and thank the three of you for your excellent testimony. It's been very, very helpful, and I know we are going to be getting back to you over the next 2½ weeks, as we try to take the best of what is in the administration plan and take care of the fatal flaws that you-all identified. Thanks ever so much for being here. I really appreciate it. We will be back in touch. Thank you, Mr. Chairman.

Senator **Cranston**. Thank you very much. I may cover ground that was covered in my absence when I had to go vote, but I would like to ask also how you feel and, again, somebody comment and let's have any counter remarks, about the way goodwill is handled in the administration proposal.

GOODWILL IN THE ADMINISTRATION PROPOSAL

Mr. **Fleischer**. The administration proposes amortizing goodwill over a period of 10 years. I suggest that if it is possible to conduct the banking industry safely without real capital, banks which did not participate in regulatory mergers could likewise function without real capital. I think that the only value that goodwill has is zero, that for capital purposes, goodwill should be considered zero, and to the extent that institutions ~~have engaged~~ in transactions with regulatory authorities, on the assumption that they would be able to use goodwill as capital, just compensation in some way be effected or the transactions rescinded. I believe it is fatal to the industry to allow any institution to continue without real capital in place.

Mr. **Ranieri**. Senator, I believe that is a very noble idea about replacing the goodwill with assets or rescinding the transactions. I am not sure how practical they are, and since I am not sure it is practical, I think, unfortunately, you are faced with a moral dilemma, because I also don't believe goodwill should be capital, but you have a very obvious moral and practical dilemma. The moral dilemma is these people entered into these transactions in good faith with, in fact, their regulator who asked them to. The practical dilemma is, if you don't count the capital, you are going to be back here tomorrow for another $100 billion. It is a big number of institutions that can't conceivably make the test if you don't give them a phase in on the goodwill.

So the issue is, not that I think goodwill is capital, but practically speaking, from the point of view of the Congress, what is a reasonable phase-in that doesn't cost you more than the money you are trying to get. This is the only place where I actually do have some sense of mercy for the thrift industry in general, you know, on this issue of supervisory capital, capital that came from supervisory acquisitions.

Mr. **Sandler**. At the risk of making myself unpopular with those with whom I am already not popular, I have a different point of view on goodwill. I can't think of any institutions or if there were any, they were very few; I don't think there were very many institutions who made acquisitions and said, "Golly, I really want to help the FSLIC. That's my motivation." Let's not kid around. I made a supervisory deal back in 1982 which involved goodwill and many others made deals that involved goodwill and we thought we would do it because we were going to make money not because we were good guys who FSLIC owed something to.

I take significant disagreement with an allusion by Mr. Fleischer earlier that Empire Savings, which has approximately $1 billion in goodwill, ought to be taken out of that. I looked at the deals that Empire was making at the time, and I said these deals are economically insane, FSLIC was wrong to have made them and Empire must have been crazy to have entered into them, and to take the concept that we are going to give them $1 billion to fill the hole which they played and built by themselves is the height of sheer insanity.

Now what is capital for? Real capital is there to protect FSLIC, the FSLIC fund, the public and to protect well-capitalized institutions from insane operators who have no money at risk.

Now you have the balance questions. Institutions took on goodwill for the purpose of making money in those deals, but they took it on under a certain set of rules, and what you are doing is, you are changing the rules in the middle of the game. Now the problem is, which side should have more influence on you? The FSLIC fund, the public and the well-capitalized companies or the rules of fairness? And what Congress has to do is strike a balance. Either extreme is unfair. It is unfair to wipe out the capital, and it is unfair to say that goodwill counts as full capital.

This is probably the one area, if I can pick one area, where I think the administration actually came up with something that is somewhat rational. They said, Look, you've been writing this stuff over 25 and 30 years, and if I understand their proposal, they are saying, for income purposes, for P&L purposes, you can still write it off over that period of time, but for the purposes of calculating capital, you write it off over 10 years. I think that is an eminently fair balance, and I wish they took the same approach elsewhere in the legislation.

Senator **Cranston**. I would like to address a question to you, Herb. There has been a lot of debate in these hearings over what have been called risky, nontraditional activities of State-chartered S&L's. I understand that there is a good deal of risky activity in the more traditional thrifts that happen to have Federal charters. For example, isn't it the case that many of the largest traditional California home mortgage lenders have billions of dollars in retained subordinated interests in mortgage loans, and isn't that pretty risky, financially?

RISKY ACTIVITIES BY STATE-CHARTERED S&L'S

Mr. **Sandler**. I agree that that is risky, and as a matter of fact, in our draft we should have included as an exception the issue of residuals, but you are sitting next to probably two of the country's leading experts in the area of residuals, and I am just a pure layman in their company, and I would defer to them.

My personal reaction is that these two gentlemen probably know how to deal with them. I don't think I could count on the fingers of one hand the others who do and whom I would trust 50 cents of my money with.

Senator CRANSTON. Lew, do you want to comment on that?

Mr. RANIERI. The issue of a topic like residuals is, in fact, a great moral dilemma, and when—God rest his soul—when Bryce Curry died and we had the seminar in his honor in New York over 1½ years ago, I warned the industry then that I believed thrifts were purchasing residuals which would blow them up, because they had no idea what they were buying, not because all residuals are bad, but because they are very powerful tools. In the same way you don't give, much less, guns to children, you don't hand them grenades. And the supervisory system either had to make up its mind that it was going to be able to tell who was allowed to do what to whom or, in fact, again, unfortunately, regulate to the least common denominator.

I guess I am still in the same position. I hate regulating to the least common denominator, but unless we find ways within the regulatory process of being able to determine who has expertise and who doesn't, and then some classes of assets have to be prohibited.

Senator CRANSTON. Herb, do you——

Mr. SANDLER. There's another expert here. [Laughter.]

Senator CRANSTON. Ernie, do you want to comment too?

Mr. FLEISCHER. There are two different ways in which residuals have been used in the industry. One is to take on the residual credit risk, and I believe that is the example that you gave, Senator. The other is to take on the residual interest rate risk. Both could have a proper place in portfolios of thrifts, depending upon the overall level of credit risk or the overall level of interest rate risk that exists. In fact, both might actually, in a proper portfolio, reduce the level of risk within the total portfolio. The only way in which the proper use of those residuals could be measured is by determining the risk of the portfolio as a whole, as distinguished from the risk of the individual asset within the portfolio.

Senator CRANSTON. Herb, I would like to address this question to you. Do you grant that there are risks even to those institutions that focus entirely or almost entirely on home mortgages, whether they be a fixed or adjustable rate with adjustable rates having annual lifetime caps of one sort or another, in view of the unpredictability of interest rates which might go very high and obviously, depending upon the quality of management.

Mr. SANDLER. Inherently, in any intermediary function, there is risk involved. The question is, are they appropriate risks and are the activities in which the intermediary is engaging in the public interest. Homeownership, consumer loans, are in the public interest. They are risks that can be managed relatively well by relatively competent people. And I think a great distinction between those kinds of risks, which are traditional risks, and which did not cause the losses that we are dealing with today, are appropriate. And that is the job of management.

There are other kinds of risk that fall outside of those areas which are far more significant.

Senator CRANSTON. Any comments?

Mr. RANIERI. No. I agree.

DISPOSAL OF ASSETS OF INSOLVENT INSTITUTIONS

Senator CRANSTON. How do you believe—any one of you again can comment on this—that the assets of insolvent institutions should be disposed of? We are hearing a lot of statements made about a fire sale going on with imprudent sales at low cost just to get cash, and a lot of people are wondering if there isn't some better way to handle that situation that would ensure that we get maximum value ultimately from those properties.

Mr. SANDLER. Again, fools rush in where angels fear to tread. This is obviously a hot issue. As I understood the administration plan originally, the FDIC was to be charged with this responsibility, and there is a significant concern whether they will dump assets. I get very nervous in this area, because I think, and I hope I am wrong, that the next major political financial scandal is going to come out of the sale of the $150 billion to $200 billion in real estate assets that will be disposed of. What a field day for political contacts and friends and game playing. And I am telling you, I am absolutely petrified, and I think you're between a rock and a hard place. If the FDIC does it, you have the concern of dumping and the impact on values in the various areas, and if you delegate it out so it is part of the political system under the administration, cronyism and all other kinds of potential dangers lurk.

I am really worried, and I think you put your finger on a big, big part of the problem.

Senator CRANSTON. How do we protect ourselves and the public against that?

Mr. SANDLER. I'll tell you, I have been so focused on trying to figure out the financing proposal, I haven't gotten to the next step yet.

Senator CRANSTON. Well, we have to start marking up this bill in about 2 weeks.

Any other?

Mr. FLEISCHER. Among my roles in the thrift industry is the role of chairman of Heartland Savings. Heartland is a billion dollar Oklahoma association, which is the successor to Frontier, another Oklahoma billion dollar association. Heartland's assets include a race track in Wyoming, which I believe is the only federally operated race track in the United States. [Laughter.]

Senator CRANSTON. You would be surprised what the Federal Government is operating in various places. [Laughter.]

AUCTIONING

Mr. FLEISCHER. Hotels in Utah and Massachusetts and Florida. The way in which we are proceeding to handle those assets is to pay a very large fee monthly for managing those assets with an eventual negotiated sale. My strong recommendation with respect to sales is to do those by public auction as quickly as possible. In the event that the Federal Government has skills of going out and buying distressed real estate, taking that distressed real estate and making it profitable, that might be an appropriate way to use Federal revenues. I do not believe those skills exist. I know that Heartland does not have those skills, and I think it is a waste of public money to do anything other than have an immediate auction.

Second, the overhang of these assets while they are being held for sale has a depressing effect not only on the market values of continuing entrepreneurs within that market area, but in addition to that, preclude those entrepreneurs from taking essential steps to develop their own property, because they do not know nor do lenders know what real market price is. In order to effect these sales, I would suggest an immediate appropriation. In the event that that is not done, the cost in the long run will be significantly more for the taxpayer.

Senator Cranston. Any comment from the other two of you on the idea of auctioning?

Mr. Ranieri. I guess I have to make a comment. I guess I generally agree with what Ernie says with a caveat, and I think over time that the cost of this resolution, in fact, would have been minimized by the value of the stock in some of these institutions the Bank Board got, but also because—again, in the only part of the world I know reasonably well at this point, which is in Texas—some of these institutions have remarkably good assets that, in fact, will appreciate faster than the cost of carrying them, even if that cost in some of these deals is excessive. For the Government to liquidate those assets now, there is no hope of recovery. I mean, you know, whatever the number is, the number is.

I think that you really don't have that luxury to have just auctions in general, because look at what happened the last time the Government tried that, and it was only a few months ago, when the VA and HUD, along with some of the other agencies, found themselves in possession of most of the residential market in Denver, and they all decided they were going to sell at one time. Well, you know, they managed to decrease the housing values in Denver by 10 percent in a matter of 2 weekends, and by the way, create some new insolvencies that weren't there beforehand.

I am sure they can liquidate anything they want in Boston, MA, but in some of these areas where the real estate is so largely concentrated in the hands of the Government, it just can't reasonably be sold in a very short period of time. If you are trying to sell 10 houses and there are 2 buyers, you can mark the 10 houses down as low as you want. You are still only going to sell 2 houses.

All right. That is the position the Government finds itself in in many jurisdictions. So in general, I agree with what Ernie is saying, but with the caveat that there are some areas that it is impractical. There are frankly some properties where, for the Government to sell them at this point in the cycle in some areas, and I realize I am making a real estate judgment, you know, is to give away all of the recovery. It is to take all of the losses and get none of the up sides.

Senator Cranston. Herb, any further comment?

Mr. SANDLER. No. I agree. We have watched it happen in Denver and what Lewie describes is exactly accurate.

Senator CRANSTON. Some people have suggested we go to a REIT approach on disposing of assets, sell interest to the public, have it managed by private industry with the Government and investors slowing the upside.

Any comments on that idea?

REIT APPROACH

Mr. FLEISCHER. I do not believe that real estate speculations with or without the REIT is a proper role for the Federal Government. Again, if the Federal Government has a market advantage in that area, it could, of course, engage in that area in competition with those in the private sector who are going in and reduce significantly the amount of taxes that would have to be collected. Nobody would even suggest that being done today; however, once the Government is in possession of the property, the idea becomes appealing. I think that ultimately the more the Government engages in these types of activities, the greater the cost.

In a speech that Mr. Siedman made to the National Council during this week he quoted Milton Friedman to the effect that if the Government would be given the management of the Sahara Desert, there would be a world shortage of sand in 5 years. [Laughter.]

Senator CRANSTON. This could be privately conducted as an alternative. The REIT could be a private operation.

Mr. FLEISCHER. To the extent that the Federal Government had no role in it and that the assets or a beneficial ownership in the assets was immediately sold at market, that would be fine. I simply want to get the Federal Government out of the business.

Senator CRANSTON. I want to touch finally on two of the major problems that we are wrestling with where there are widely different opinions in testimony we get and on the committee. One is the issue of who pays. Herb made a very strong case, as have others, that if we seek too much from the industry itself—there is also a question of where that money goes—that we put many institutions in danger that are not now in danger.

The other side of that in part is the reluctance by Members of the Congress to impose the total cost on taxpayers, which can lead to some anguish and some protests on their part. I recognize that if we put the burden too much on institutions and we force some into insolvency that are not now threatened in that fashion, the ultimate cost to the taxpayers is going to be greater and there is going to be more disruption, generally, and income losses to the Federal Government from taxes, and so forth.

Where do we strike a balance on that?

WHO PAYS?

Mr. SANDLER. May I start with a biased comment. I have a little problem with your premise. Do you folks in Congress have any difficulty if there is a drought in Iowa in appropriating money that the President sets aside because you had a natural disaster there?

Senator CRANSTON. No.

Mr. **Sandler**. I don't really hear a lot of discussion. What you have had is a natural disaster in the savings and loan industry, and the only difference between that and the drought in Iowa is that the drought in Iowa was an act of God and the S&L disaster was caused by the Federal Government—administration, Congress, OMB, inept regulators. Where is there a difference in concept other than your own anger at what took place? Why don't we get angry at God when there is a drought, and we get angry at other innocent parties when there is something like this? I have a basic problem with that.

I know I have to move on since I am conscious enough to know I live in the real world and I have to face the question you asked, but I wish you folks would think about it a little bit more in that concept and not look at it—it's not really the taxpayers and these bad S&L's. We're the taxpayers too. We're a very large taxpayer, and we did nothing wrong, and I fail to understand the concept in this country whereby innocent people, because they are in the zone of damage, have to pay something. Where does that come from? If Ernie Fleischer is going to rob a home and I know about it and I call you, the police, and warn you about it, and you ignore me, and then Ernie is about to, in fact, do it, and I see him doing it, and I call you, the police, again and say he is doing it, and you do nothing. And then Ernie takes the money, he runs away, as some of these savings and loan operators did, and then you arrest me and put me in jail? That's what's going on here.

Well, I know I haven't answered your question, but I had to get that off my chest. [Laughter.]

Senator **Cranston**. I recognize that your institution, specifically, and I am sure the institutions represented by the other two gentlemen at the table, have conducted your affairs in an honorable and a very sensible way. Part of the anger stems from the fact that there has not only been government mismanagement but a lot of fraudulent and corrupt and criminal activity by some people in the industry.

Mr. **Sandler**. That's right. But they are not the people whom you are asking to pay. That is exactly why I used my example. Ernie Fleischer has taken the loot from the apartment and he's ran away with it. He's gotten away scot-free, and you are turning to everybody else who had nothing to do with it, and in the case of many of us, warned you about it, and our warnings were ignored and still you are coming back to us.

Mr. **Ranieri**. Herb, I've got to put my two cents in. The difference between the natural disaster, you know, is, when the natural disaster occurs, your trade organizations don't come up and say, "Well, it really didn't happen, guys," or "It really was only two trees in the vineyard." And unfortunately, whether we like it or not, we are all going to pay because our representatives refused to acknowledge that the natural disaster occurred.

Mr. **Sandler**. Lewie. Lewie, we paid $5 billion for the incompetence and whatever else you want to call it of the U.S. League. That is a pretty big bill to pay for an incompetent trade association, isn't it?

Mr. **Ranieri**. It's a big bill, Herb, but—look, I made the point in my testimony that what you have to remember about Texas is, you know, all the commercial banks failed. Think about it. There was a point very—you know, 6 years ago, where the only Triple A banks, with the exception of the Morgan Guaranty, were all in Texas. They walked on water, those guys down there. All right? They were the greatest banks in the world. Every single one of them, without exception, failed. It wasn't the thrifts in Texas that failed all by their lonesome. They had lots of company. The marginal operator in New England, whether he was a thrift or a commercial bank, succeeded. The best operator in Texas died. The one thing you have to remember is, this was not solely an issue of total incompetence. I agree with all of that, but the fact is, the problem was compounded and magnified in terms of its cost to the taxpayer by the meddlesome effect of a whole bunch of people, some of whom, certainly, were in the industry. So we are going to pay the bill. Believe me, I don't like it either. I wasn't even in the industry; I'm going to pay the bill.

Mr. SANDLER. That's all the more reason you should. I've always favored guilt by association, Lew. [Laughter.]

In answer to your question, Senator Cranston, clearly, you are going to hit the industry with something, and the best place to hit the industry, which is fairest because we can quantify it, is by causing us to pay a higher premium for X number of years with ultimate equality. All this contingent stuff is just game playing, and that ought to be eliminated. Tell us how much you want. We will then know what it is. We can plan for it. It won't chase away outside capital. All these hidden and contingent things frightens away outside capital and that is the death knell.

Senator CRANSTON. Lew, I have been asked to see if you have any idea on the REIT idea.

Mr. RANIERI. Actually, I like the REIT idea, because of my two premises that there are some areas the Government can't sell everything for practical purposes, and then there are, in fact, also some assets the Government shouldn't sell because they will be worth much more in the future than they are now. OK, how do we fund those little puppies in the meantime? And one very effective way of doing that is, in fact, through an idea like a REIT idea. In fact, before the Bush plan, the Home Loan Bank was exploring, as an example, a proposal with one of the big pension funds in Texas, where the pension fund would fund a billion dollars worth of the Texas real estate assets at a rate which was below Treasury's, in order to get a portion of the up side in those assets. So, in fact, a REIT idea, it can be a very effective way of funding those assets in an interim period at a cost that would actually, in many cases, might even be lower than the Treasury rate itself.

So I think there is some reasonable merit in that proposal. I am sensitive to Ernie's point, but I think you can do a private-public sector deal that could accomplish that.

Senator CRANSTON. I think another major, major difference of opinion, both in testimony to us and among members of this committee, relates to the State powers and Federal powers matter. There has been a lot of discussion on the effort to restructure and recapitalize the Federal Home Loan Bank System in that respect. This issue has been mistakenly characterized, I think, as a debate over conservative Federal powers versus liberal State powers, the implication being that Federally authorized powers are safer for thrifts than State powers and that all State chartered thrifts should be confined under the new regulations to only those powers authorized under Federal law.

According to data from the Federal Home Loan Bank Board there was an equal proportion of failed thrifts from both Federal and State charters; however, in late 1988, 56 percent of the resolutions had State charters. The conclusion of the Federal Home Loan Bank Board is that the misuse of all powers available to thrifts, all powers, caused failures for one reason or another in various institutions.

Direct investments in themselves appear to explain only a small portion, 2.6 percent of assets in the industry of failures over the past 5 years. An overwhelming number of thrifts failed because of imprudent commercial real estate lending, acquisition, construction and development loans, where the only security for the loan was the land, and the developer had no personal liability of any sort. Many thrifts have failed, betting on interest rate risk on the traditional mortgage portfolio, as we discussed a bit ago. Even traditional mortgages, whether fixed or adjustable, we have agreed, can be risky. Nevertheless, I do not want to downplay the role of States and, particularly, California, that gave thrifts 100 percent investment powers in almost any activity with hardly any regulation at all.

But it seems to me that we must duly consider the fact that numerous healthy institutions, healthy today and healthy steadily, have handled their investments in a prudent matter with proper capital and diversification of powers.

The argument is made by some that we should only guarantee deposits for Federally chartered institutions or State chartered that comply only with Federal investment standards.

What are your comments on that situation?

THE MATTER OF FEDERAL POWERS AND STATE POWERS

Mr. FLEISCHER. With respect to the various activities, I attended a seminar in December sponsored by the San Francisco Federal Home Loan Bank. At that seminar, Mr. Kaplan of Kaplan & Smith, now a First Boston subsidiary, gave a report at the request of the Bank concerning those activities in which thrifts have engaged which have, during the 1980's succeeded and those activities which have failed.

In reviewing information publicly available, Mr. Kaplan's conclusion was that in all areas thrifts had succeeded and in all areas thrifts had failed. It was primarily a question of the human capital at that particular thrift or a geographic or other market advantage that the thrift had.

Accordingly, I do not believe that there is any magic in either the Federal or the State powers but would suggest that the real key is the sensitivity of the thrift's portfolio to various changes in interest rates or economic events that might cause a loss of that thrift's equity and, accordingly, the loss to the fund.

Senator CRANSTON. Thank you. Any other comments?

Mr. **Sandler**. It seems to me that if you don't pay the bill, you don't make the rules. The arguments for State powers are: States' rights, the ability to experiment, and third, the one that has just been alluded to by you, there are good operators who have been able to work with State powers which they wouldn't have under the Federal system. The best analogy to me would be an insurance company in which you authorize the salesmen to determine what the insurance rates are. No State has any stake in increased safety. They have a political stake in making their constituents happy, since they don't have to pay any bills.

I think it is fine to let there be all the State authorities you want, as long as the States will pay for any losses that come out of that. If they don't, it is up to the Federal Government, since they have to pay the bill.

Mr. **Fleischer**. Herb, the power doesn't create the loss. It is the way in which the power is used, and if we can put in Federal legislation limits on the risks that are undertaken, the power itself can be there, if the risk is handled prudently. I don't think the issue is the power itself. It is really the risks which must be controlled by Federal legislation.

Senator **Cranston**. Any comment on that, Lew?

Mr. **Ranieri**. I am not so sure that there is a tremendous amount of difference between what is allowed under a Federal charter and what is allowed under a State charter. I mean, actually, the differences are much less than you think. It is largely a difference of degree. How much of it you can do rather than if you could do it at all. I mean, I am not the world's leading expert on this, but if my memory serves me, there is frankly not very much that you can't do anymore under a Federal charter that you can do under a State charter.

So I don't frankly think that State charters are terrible, as long as there is some boundary, in terms of how much of it there is. If you say you can do any amount of it, and that is what State charter means, and you can do it in a way that is different in terms of capital than a Federal, then I would have a problem. So I think you can resolve this State-Federal issue a lot more easily than saying black or white, yes or no. But I am not the world's resident expert here.

Mr. **Sandler**. Why don't you help me with this hypothetical. In the State of California, the State chartered institution, either directly or through its service corporation can put all of its insured deposits into common stocks. Please write the regulations for me.

Mr. **Ranieri**. Say that again, Herb?

Mr. **Sandler**. In the State of California, either directly in the savings and loan or in the service corporation, you can take all of your insured deposits and invest them in common stocks. Aside from the question about whether that is an appropriate use of insured deposits, please write me a set of regulations that you think makes any sense.

Mr. **Ranieri**. I'll take a shot at it. I think the issue again is, you know, within your 40 percent basket—I am not sure why you want to do common stocks, but if you want to do it within your 40 percent basket, I think the issue again becomes how much of it you are allowed to do and what the capital that you are going to ascribe to it is. And by the way, I am not the great fan—I am a Federal charter myself and find myself cast in a strange position defending State charters. But that is how I would address the problem. I agree, Herb. You shouldn't put 100 percent of your deposits into common stock. That is an issue of degree.

Are you saying, let's pass a finite rule because it is the Eleventh Commandment no thrift should own common stock?

Mr. **Sandler**. Yes.

Mr. **Ranieri**. OK. So that is not an issue of State charter, Herb. You are saying that no thrift, whether Federal or State, should invest in stock. You made my point for me.

Mr. **Fleischer**. Let me try, Herb. [Laughter.]

Mr. **Sandler**. Sorry I asked!

Mr. **Fleischer**. The suggestion which I have made is that the business plan submitted by the thrift must satisfy reasonable bounds of profitability. If a thrift has agreed to pay interest in fixed dollars, there is no way an investment in 100 percent of common stocks would accommodate reasonable profitability. Accordingly, the risk management issue would override the power issue. That is, the power would be there, but investing 100 percent in common stocks would not be reasonably profitable.

Senator **Cranston**. Let me say one general matter where I am not necessarily asking for a response now, but I would like you to think about it. One problem we are going to have is reluctance on the part of Senators and I think House Members too, many of them, to support anything proposed that could be interpreted as reducing or watering down the administration's proposals, just on the grounds of we would then be vulnerable, those that have that concern—I don't particularly, but some Members do—vulnerable to charges that we were the cause of any future havoc that develops.

Some of you and some other witnesses, a good many other witnesses, have urged upon us certain steps, certain revisions that could be viewed as watering down, but the case that some of you have made is that if we don't water down in that way, some thrifts are going to get into trouble and we are going to have less thrifts surviving, less tax revenues from them and less fees paid by them.

Where you or other witnesses have advocated anything in the form of a change in the Bush administration proposal that can be interpreted as a watering down, I urge you to think through now it can be presented and a case made for it in a way that if it is not done, the problem gets even worse and the Bush administration and Congress and the thrift industry generally, and hence, the bill to the public is going to be even worse. We need that kind of ammunition.

WATERING DOWN THE BILL

Mr. **Sandler**. Actually, Senator Cranston, of the three things which I mentioned, which I think both Ernie and Lewie agreed to, not all of them involve a watering down. For example, the 35 basis points, which is applicable both to banks and savings and loans, is not raising any money at this time. It is something in the future and can be handled, but Lew's suggestion that that be left to Congress to make that determination is not a watering down. It is really not a watering down to decree equality of premiums with banks, because where we end up is at 18, and where they end up at 15, and it is not a watering down, for example, if we both ended up at 16½.

So that is not a watering down. It is not a watering down to take the Federal Home Loan Bank credit mechanism, not the supervisory and regulatory mechanism, but the credit mechanism and take it out from the aegis of the Treasury where it is destined to death.

So the only area which could be considered a watering down in any of the proposals I have made is the Federal Home Loan Bank.

Mr. **Fleischer**. I have not suggested any watering down. What I have been concerned about and continue to be concerned about is that the bill fails to address the risks which exist today and will continue to exist within the banking and thrift industry, unless Congress deals with those risks in this bill.

Senator **Cranston**. Let me say at this point that this hearing has gone on much longer than was anticipated. I have not run out of questions, but I have run out of time. I guess the committee has also, as a whole.

Let me just state where we go from here. I am speaking my understanding of what Chairman Riegle intends, just for your information. This is the end of the hearings. The staff will be working throughout the time when the Senate is not in session now preparing a committee print, based upon the advice we have received and whatever consensus we have developed, and we have developed, I think, some among the members of the committee, to some degree at least, and that committee print will become the basis of our marking up, trying to agree on a bill as soon as we return in early April.

Our goal is to get that bill reported out rather swiftly and have that bill reported to the Senate and acted upon by the Senate as early as possible in the month of April.

So that is where we are now going to devote our energies and time.

I want to thank all who participated today and on other days on behalf of the whole committee.

We now stand in adjournment. Thank you very much.

[Whereupon, at 1:15 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

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Testimony of

David R. Conrad

Water Resources Specialist

for the

National Wildlife Federation

Regarding

the Flood Insurance Aspects

of

S. 413

"Financial Institutions Reform, Recovery and Enforcement Act"

Before the Senate Committee on Banking, Housing,
and Urban Affairs

Submitted for the Record

March 24, 1989

I appreciate the opportunity to submit testimony for the Committee's record on S. 413, legislation entitled "Financial Institutions Reform, Recovery and Enforcement Act of 1989". My name is David R. Conrad. I am the Water Resources Specialist for the National Wildlife Federation. The National Wildlife Federation is the largest not-for-profit conservation organization in the nation, with more than 5.2 million members and supporters. The Federation seeks through this testimony to address certain important flood insurance-related concerns that we believe are relevant to the legislation before the Committee.

With the immense sums that the U.S. taxpayer has recently paid and even greater sums that will soon be required to resolve problems in the savings and loan industry, it is obvious that unhealthy lending practices do great harm to all Americans. One area of significant failure by the nation's lending industry, which has received too little notice to date, is the failure of both healthy and ailing lenders to require flood insurance, as required by the Flood Disaster Protection Act of 1973, for large amounts of improved real property located in areas subject to statistically inevitable floods and flood damages. By failing to notify and remind the public of the risks of possible flood damages and by failing to require the purchase of flood insurance for insurable structures, homes and businesses, where mandated by current law, many federally-insured lending institutions are underwriting environmentally and financially unwise investment.

Through the National Flood Insurance Program, the Federal Emergency Management Agency has identified most areas in the United States which are subject to flooding with a recurrence frequency of once in 100 years (generally referred to as the "one-hundred year floodplain" or "special flood hazard areas"). This defines an area with a 26% likelihood of flooding during the life of a 30-year mortgage. The large amount of uninsured property located in special flood hazard areas which secures loans made by federally-insured lending institutions and which is subject to the risks of flood damage may place at significant and further risk the stability of a number of banks and savings and loan institutions, particularly in areas subject to catastrophic storms such as major hurricanes. In addition, it undercuts the ability of the National Flood Insurance Program to discourage unwise floodplain development and to eliminate the need for environmentally damaging flood control measures.

The National Wildlife Federation urges the Senate Banking Committee and the Congress, in developing its version of the "Financial Institutions Reform, Recovery and Enforcement Act", to:

- establish penalties for federally-insured lending institutions' failure to comply with the mandatory flood insurance purchase requirements of the National Flood Insurance Program;

- improve the notification requirements of lenders to annually inform mortgagors of the requirement of flood insurance and the risk of flood damages to their properties; and

- bar federally-insured lenders from issuing real estate loans secured by properties in special flood hazard areas unless the community where the property is located participates in the National Flood Insurance Program.

Such changes would constitute appropriate and necessary steps in the comprehensive effort to resolve problems permanently and limit large and unnecessary risks facing the Federal Savings and Loan Insurance System and other federal insurance systems.

Current law mandates federally-insured lending institutions to require flood insurance for mortgages and loans secured by properties located in special flood hazard areas.

The National Flood Insurance Program (NFIP) was established by the National Flood Insurance Act of 1968 (Title XIII of the Housing and Urban Development Act of 1968, as amended, P.L 90-448, 42 U.S.C. §4001-4128) to provide previously unavailable flood insurance for properties located in flood-prone areas and to encourage communities to adopt sound floodplain management regulations to guide the development of future construction away from locations threatened by flood hazards. Conservation organizations, including the National Wildlife Federation, have supported the flood insurance program because of its potential to protect the considerable natural and recreational values of low-lying flood-prone areas and to reduce the need for environmentally damaging dams and levees for flood control.

In 1973, in order to encourage greater participation in the NFIP, Congress enacted the Flood Disaster Protection Act (P.L. 93-234). Section 102(b) (42 U.S.C. §4012a(b)) of this act, as amended, requires that each Federal instrumentality (federal financial regulatory agency) establish regulations that direct banks, savings and loan associations, or similar institutions (i.e. federally-insured lending institutions) not to make, increase, extend, or renew a loan secured by improved real estate or a mobile home located or to be located in certain areas, unless the property securing the loan is insured. This section applies to property located or to be located in a community participating in the NFIP and in an area that has been identified by the Director of FEMA as a special flood hazard area (SFHA). The property securing the loan must be covered by flood insurance for the entire term of the loan in an amount equal to the outstanding principal of the loan or to the maximum limit made available under the NFIP, whichever is less. The SFHA is defined as the area statistically subject to flooding at least once in a one-hundred year period, which translates to the area with a 26% likelihood of flooding during the term of a 30-year mortgage.

The original 1968 act established the Federal Insurance Administration under the Department of Housing and Urban Development. In 1978, the responsibility for administration of the NFIP was transferred to the Director of the Federal Emergency Management Agency (FEMA) and is delegated to the Federal Insurance Administrator.

To assist lenders in enforcing the law, FEMA has developed detailed maps identifying over 18,000 flood-prone communities. Currently, 17,797 communities participate in the NFIP, and about $800 million has been spent by the federal government for mapping such flood hazard areas. Clearly, the federal government has invested a great deal of money in this program and must ensure that lenders carry out their critically important duties under the NFIP.

The lending industry has failed to require flood insurance for most mortgages and real estate loans secured by property located in special flood hazard areas.

For some time it has been a serious concern of the Federal Emergency Management Agency (FEMA) and state floodplain managers that compliance with the flood insurance purchase requirements by federally-insured lending institutions has been far below what it should be. FEMA has been attempting to quantify the level of noncompliance. In several recent studies FEMA has concluded that **the percentage of households within 100-year floodplains that have been insured is only 13 to 14 percent nationally**.

In a letter to Senator William Proxmire of July 6, 1988, in follow up to FEMA's testimony before the Senate Appropriations Committee, Harold Druyee, the Administrator of the flood insurance program, reported that a 1987 study conducted by EDS Management Corporation for FEMA included a computer check on over 1.5 million mortgages being serviced by lending institutions of various sizes. The EDS study found, with respect to almost 170,000 mortgages on buildings located in special flood hazard areas, that less than 25,000 or 14% had a flood insurance policy in effect.[1]

FEMA also recently completed a report on the number of uninsured households in special flood hazard areas in an attempt to identify the "market penetration and potential" for sales of flood insurance under the National Flood Insurance Program (NFIP). There are at least two disturbing facts presented in this study. First, FEMA finds that only 1.4 million of an approximate 11 million insurable households in the SFHA are currently protected by flood insurance. This represents approximately 12.7% of total households located in the 100-year floodplain. Second, the study identifies a trend toward higher concentration of development in flood-prone areas. The study estimates that the national percentage of dwellings located in SFHAs has increased from 10% in 1966, to the current estimate of about 14%.

The study notes, "[d]uring the late 1960's, as well as all of the 1970's and 1980's, there appears to have been a greater concentration of development in the nation's flood prone areas, as the safer, less hazardous undeveloped areas, have become more and more scarce. This practice is probably most evident along the East and Gulf coasts but is by no means limited, exclusively to those areas. Such trends are only expected to continue, further increasing such concentration and the exposure and accompanying risk associated with such areas."[2]

If FEMA is correct in its estimate that 9.6 million households located in SFHAs are uninsured, then a reasonable estimate of the value of uninsured flood-prone property translates to over **$670 billion** (based on 1987 Department of Commerce average value of $70,255 per 1-4 family household).

Certainly not all properties are required to carry flood insurance under the NFIP. Exceptions include properties without mortgages, properties located in nonparticipating communities, properties with mortgages in place before the mandatory purchase requirement became effective, and properties with mortgages not held by federally-insured lending institutions. However, once again, FEMA's study on market potential points out that there are an estimated nine million sales or resales of household units each year with some one million of these in SFHAs, but there are only 400,000 new policies purchased each year (which is offset by about the same number which fail to be renewed).

By any measure, many more flood insurance policies than the 1.4 million policies currently in force in the nation's 100-year floodplain should be in effect.

FEMA generally cites lack of lender awareness as the reason for the high degree of noncompliance, but in the FIA Administrator's July 6, 1988 letter to Senator Proxmire, the Agency refers to the fact that no penalty upon lenders exists. "We [FEMA] believe that the solution to this problem lies in continued efforts to educate those lenders who ignore the flood insurance purchase requirements because the Act does not provide for any penalty upon lenders."[3]

The magnitude of potential property damage to uninsured properties from major storms could threaten the financial stability of lending institutions with real estate loans in areas subject to special flood hazards.

It has been a decade since the United States experienced a major hurricane and its associated flooding. In September of 1979, Hurricane Frederic destroyed more than $2.3 billion in property when it struck the Gulfport, Mississippi area as it crossed the Gulf coastline near Mobile, Alabama. Frederic became the costliest hurricane on record as of 1985.[4] Also in September 1979, Hurricane David (which was only a Category 1 storm when it hit Florida) left perhaps $500 million in property and crop damage.[5]

The insurance industry has recognized that the potential cost of major hurricane damage has risen greatly in recent years. To analyze the effects on the U.S. hazard insurance industry of two catastrophic hurricanes in a given year, the industry's All-Industry Research Advisory Council (AIRAC) commissioned a study entitled, "Catastrophic Losses: How the Insurance System Would Handle Two $7 Billion Hurricanes." The Council writes that "[a]lthough no hurricane striking the U.S. mainland has ever caused $7 billion in insured losses, storms of that magnitude are now possible because of the large concentrations of property located along the Gulf and Atlantic coastlines of the United States."[6] The study by AIRAC analyzed hurricane wind damages associated with two theoretical catastrophic storms, one on the Texas and Louisiana coasts and another following a track similar to that of Hurricane Donna which caused extensive damage in Florida and New England in 1960. The study found it "relatively easy to structure an East Coast storm that could cause $7 billion in insured losses because of the large urban areas located there."[7]

While a similar study projecting flood damages from such storms has not been done, it is obvious that damages could be extremely high. In an analysis done by FEMA of potential Texas households at risk from a storm the size of Hurricane Gilbert, which ravaged Jamaica and Central America in September 1988, FEMA found that a total of 155,000 coastal area households had flood insurance coverage while an additional 492,000 coastal area households were at risk but uninsured.[8] If Gilbert had struck the Texas coast, the government would have faced the possibility of billions of dollars in claims, far more than current reserves in the National Flood Insurance Fund. In addition, homeowners and mortgage holders likely would have sustained enormous uninsured losses, increasing the costs of disaster relief assistance and casualty tax write-offs as well as adding to the already enormous financial difficulties of many lending insitutions.

Since thrifts originate and hold a large percentage of home mortgages (nationally as much as 50% and 40%, respectively[9]), a catastrophic storm in an area such as Texas, Florida, or New England could further weaken the financial positions of thrift institutions with large numbers of uninsured home loans in floodplain areas. There is no reason for the U.S. taxpayer to shoulder, through the federal deposit insurance system, the risks of uninsured, flood-prone property which is required to be insured.

RECOMMENDATIONS TO REDUCE RISK

1. Congress should establish penalties for federally-insured lending institutions' failure to require necessary flood insurance in order to increase the level of insurance coverage.

A serious weakness in the flood insurance program which has fostered non-compliance with the mandatory purchase requirements of the NFIP appears to be the lack of a specific penalty for lenders who fail to require necessary insurance to be in force. It is hard to understand why lenders are not more diligent in requiring flood insurance when one considers the risks involved and the degree of effort that is usually exhibited in requiring insurance against fire and other hazards.

According to FEMA and Federal Home Loan Bank Board officials, lending institutions often will require evidence of flood insurance at loan origination, but will fail to follow up and require insurance policy renewals. While each of the federal instrumentalities have promulgated notice and insurance purchase requirement regulations which generally parrot the NFIP statutory language, the mandatory coverage issue appears to be one that lending institutions have limited incentive to pursue aggressively.

In some cases, informing a potential buyer of the flood risk associated with a property and the requirement to purchase flood insurance may discourage the prospective buyer. However, if lenders fail to inform buyers of flood risks and fail to require purchase and annual renewal of the flood insurance coverage, many of the social benefits of the NFIP will be lost. The public should be regularly reminded of the location of areas which are subject to flooding. This will itself help guide development away from hazardous areas, which are often among the most environmentally sensitive areas. The NFIP is also intended to "internalize" in part the costs to society of unwise floodplain development through flood insurance premiums. Failure to require the insurance frustrates that goal, especially where lending institution deposits are federally-insured.

To improve the level of participation in the NFIP, to further the economic and environmental benefits of providing disincentives to risky floodplain development, and to shield the U.S. taxpayer from the potential major costs of federally-insured lending institution failures to which catastrophic flood events may contribute, the National Wildlife Federation strongly urges the Senate Banking Committee and Congress to establish a clear penalty for failures of federally-insured lending institutions to comply with the NFIP's mandatory insurance purchase requirement.

We recommend that a civil penalty be established of up to $250 per violation to be levied by regulators for failure by a loan holder to require flood insurance coverage where mandated by the Flood Disaster Protection Act. Enactment of such a penalty provision, with a reasonable time period provided for lenders to come into compliance, would significantly and quickly reduce the substantial risks to financial institutions and the U.S. taxpayer posed by the current high levels of non-participation in the NFIP. The National Wildlife Federation would be pleased to work with the Committee to develop an appropriate penalty provision.

2. Congress should improve the notification requirements of lenders to annually inform borrowers of the requirement of flood insurance and the risk of flooding to their properties.

Current law requires that lenders provide two types of notification to borrowers whose loans will be secured by properties in SFHAs. Specifically, Section 1364 of the National Flood Insurance Act of 1968 (P.L. 90-448, 42 U.S.C. §4104a) requires federal instrumentalities to compel a lender to notify a borrower when the loan will be secured by property in a special flood hazard area or to obtain assurances that the seller or lessor has so notified the purchaser or lessee. This notification involves a process which includes determining whether or not the property is designated as being in an SFHA by a current FEMA map, delivering the notice to the borrower in a reasonable amount of time before closing or settlement, and obtaining written acknowledgement from the borrower of his/her understanding that the property is in an SFHA. Each step of the process must be documented and retained by the lender. In addition, Section 202(b) of the Flood Disaster Protection Act of 1973 directs the instrumentalities to require a lender to notify a borrower, whose loan collateral is in an SFHA, as to whether or not disaster relief will be available in the event of a presidentially-declared disaster, which depends upon a community's eligibility to participate and status of participation in the flood insurance program.

These notification requirements do not appear to have the desired effects that Congress had sought--increased individual participation and decreased settling in areas subject to flood hazards. More stringent and better defined notification requirements for federally-insured lenders are needed to increase public awareness of the hazards existing in flood-prone areas and of the availability of flood insurance. Increased public awareness would allow borrowers to make more educated decisions concerning living in SFHAs. The National Wildlife Federation proposes:

- An annual notification requirement should be added to the law mandating the federally-insured lender to ensure that each year that the loan is in effect, for a property in an SFHA in a participating community, a notice will be provided to a borrower to serve as an annual reminder of both the flood hazards threatening the property and the flood insurance purchase requirement. (For 3-year policies written under the "Write Your Own" program, the notice should be provided at least as often as the policy renewal notice.)

- Congress should direct each federal instrumentality to develop, with approval of the Director of FEMA, standard notices for use by all federally-insured lenders to carry out the purposes of the notification requirements of the NFIP. The standard notices should include a one paragraph "Surgeon General"-type notice identifying the special flood hazard risk and NFIP statutory requirements. In addition to the current requirements, Congress should direct that the notice be included by the lender in the loan closing proceeding accompanying origination of the loan. Each year thereafter (or 3 years when applicable) the notice should be delivered to the borrower with the flood premium renewal notice, with a record of its receipt to be returned to and maintained by the lender.

3. Congress should bar federally-insured lenders from issuing real estate loans secured by properties in special flood hazard areas unless the community is participating in the National Flood Insurance Program.

In order to limit further risky real estate investments by federally-insured lenders in flood-prone areas and to encourage communities to participate in the NFIP, the Congress should restore language originally included in the Flood Disaster Protection Act of 1973 to bar federally-insured lenders from issuing real estate loans secured by flood-prone properties, unless the community is participating in the NFIP. Under current law, without such a requirement, federally-insured lending institutions can promote new development in flood-prone areas without the requirement for flood insurance and without requirements for local government to encourage better floodplain management. This requirement was included as Section 202(b) in the 1973 Act, but was repealed in 1977, at a time when community participation and availability of flood hazard maps were limited. Subsequently, these conditions have changed. Today, the vast majority of communities with SFHAs are participating in the flood insurance program, and the bulk of the mapping is complete. Restoration of the lending restrictions on eligible but nonparticipating communities would now serve especially well to keep communities in the NFIP and assure that federally-insured lenders are acting in accordance with the goals of the NFIP.

CONCLUSION

Once again, I appreciate the opportunity to submit this testimony of the National Wildlife Federation regarding S. 413. The Federation believes that the "Financial Institutions Reform, Recovery and Enforcement Act of 1989" presents an important opportunity to correct weaknesses in the National Flood Insurance Program. These weaknesses affect the financial stability of federally-insured lending institutions as well as encourage unwise development in floodplain areas, which are often among the most environmentally sensitive. I look forward to working with the Committee in addressing these issues in the course of developing the legislation and would be pleased to answer any questions the Committee members may have regarding this testimony. Thank you.

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[1] Letter from FEMA Federal Insurance Administrator, Harold Druyee to Senator William Proxmire, Senate Committee on Appropriations, July 6, 1988, p. 2.

[2] FEMA, FIA National Flood Insurance Program, "The Number of Households/Structures Located in Special Flood Hazard Areas, the History and Background of Such Estimates," February 15, 1988; and "Market Penetration and Potential Estimates," July 1, 1988.

[3] Letter from FEMA Federal Insurance Administrator, Harold Druyee to Senator William Proxmire, Senate Committee on Appropriations, July 6, 1988, p. 2.

[4] Witten, Donald E., "Elena, 'She taunted us, she teased us & then she hit us," Weatherwise, October 1985, p. 259.

[5] "When the Next Killer Hurricane Strikes," U.S. News and World Report, September 17, 1979, p. 26.

[6] "Catastrophic Losses: How the Insurance Industry Would Handle Two $7 Billion Hurricanes," All-Industry Research Advisory Council, November 1986, p. 1.

[7] ibid, p. 4.

[8] National Flood Insurance Program, "Households Protected and At Risk, Texas, September, 1988 (Estimates)."

[9] Statement of M. Danny Wall, Chairman, Federal Home Loan Bank Board Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, March 1, 1989, p. 15-16.

Anchor Savings Bid Withdrawn

By Susan Harrigan

Miami Beach entrepreneur Ted Arison withdrew his $170-million offer to buy Anchor Savings Bank yesterday.

Arison, who received regulatory approval last Friday to offer $9.75 per share for Anchor, said he changed his mind because he isn't certain what impact the Bush administration's plan to rescue the savings and loan industry will have on Anchor and another New York-based thrift that he owns. He had planned to merge the two.

Anchor's books were "in very good shape," Arison said, adding that they had nothing to do with his decision to withdraw.

"The whole situation [in Washington] became so unclear and foggy it was impossible to proceed," he said. "It's like going in a fog toward a cliff. It's a good idea to stop walking."

Anchor's stock, which sold at $11.50 a share when the thrift went public, dropped $2.12½ to close at 4.62½ yesterday. It had traded as low as $5 before the deal was announced late last year.

Although the S&L has been considered a takeover candidate for the past few months, no other bidders but Arison have surfaced publicly.

Last Friday, regulators gave Arison approval to go ahead with his offer for Anchor. Under terms of his nonbinding agreement with Anchor, he had 15 days to negotiate a definitive merger agreement, which also would have required regulatory approval.

"Unfortunately, it was a question of timing," said Alan Master, president of Ensign Bank, the S&L that Arison owns. "No investor can, this week, determine the pricing, value or appropriateness of a transaction."

'The whole situation became so unclear and foggy it was impossible to proceed.'

Ted Arison

Arison, who has been described as a cautious investor, has backed away from two other attempts to expand his S&L operations. Yesterday, he said he had been ready to put some capital into the deal with Anchor, but not as much as might have been required if certain proposals regarding good will and thrift capital are adopted by regulators and Congress. He declined to say how much capital he was prepared to invest.

Arison's announcement last November surprised many in the S&L industry because neither Anchor nor Ensign has any real net worth. Instead, their books contain a total of $630 million in good will. Good will, a paper asset that built up when the thrifts bought failing thrifts for more than their book value, really is more like a debt because it must be written off as an expense over time.

Please see ANCHOR on Page 54

Arison Withdraws Anchor Bid

ANCHOR from Page 51

As part of a plan to strengthen the S&L industry, the White House and Congress now are discussing whether the government should not require good will to be subtracted from capital entirely, or at the very least, shorten the time over which it may be written off.

One person affected by Arison's withdrawal may be Don Thomas, Anchor's chairman and the "Anchor banker" of television fame. Although he had said he would step down, the agreement with Arison had called for him to stay on as deputy chairman. Under terms of his contract, that arrangement could have made him eligible for a payment of more than $2.2 million if he had left the thrift later. Thomas couldn't be reached for comment.

William Schneider Jr., Anchor's president, said it is "business as usual" at Anchor, despite Arison's change of heart. He said Anchor's board will meet Thursday and "address the issue of management succession."

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*NOT ADMITTED IN THE DISTRICT OF COLUMBIA

March 14, 1989

Mr. Edward Malan
Editor
Senate Banking Committee
526 Dirksen House Office Building
Washington, D.C. 20510

Dear Mr. Malan:

Pursuant to your recent discussion with Douglas P. Faucette of this firm, I am enclosing twelve copies of the statement of the Financial Assistance Inequity Relief Coalition ("FAIR") on the Financial Institutions Reform, Recovery and Enforcement Act of 1989. As I understand you discussed with Mr. Faucette, FAIR has been invited to submit its testimony for the hearing record. We would appreciate it if you would take the necessary steps to see that the testimony is inserted in the record.

Please do not hesitate to contact me if I can answer any questions or provide any assistance to you in this matter. Thank you very much for your cooperation.

Very truly yours,

MULDOON, MURPHY & FAUCETTE

Joseph P. Daly

Joseph P. Daly

JPD/par

Enclosures

STATEMENT OF THE
FINANCIAL ASSISTANCE INEQUITY RELIEF COALITION

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BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

The Financial Assistance Inequity Relief Coalition ("FAIR") is an organization of savings institutions that have assisted the FSLIC by acquiring failed or failing thrifts. FAIR's current members have approximately $150 billion in assets. FAIR was formed to voice the concerns of its members over legislative or regulatory developments which revise the terms and conditions under which members agreed to engage in their supervisory acquisition.

FAIR supports much of the Financial Institution Reform Recovery and Enforcement Act of 1989 (S.413) ("FIRREA"). FIRREA is an ambitious effort to resolve the current problems in the depository institutions industry and there is much to be commended. FAIR specifically supports increasing the capital base of the thrift industry under reasonable time tables and in accordance with risk based capital standards. However, FAIR has significant concerns with certain provisions of FIRREA as they would affect supervisory acquirors and appreciates the opportunity to express its views.

I. THE FSLIC INDUCED MANY INSTITUTIONS TO ACQUIRE GOODWILL AS A FORM OF ASSISTANCE IN SUPERVISORY ACQUISITIONS

The early 1980's saw many thrifts in trouble due to the gap between the high cost of funds (resulting from soaring interest rates) and low yielding fixed rate portfolios. Faced with large numbers of failing institutions and limited funds, the Federal Savings and Loan Insurance Corporation ("FSLIC") undertook an aggressive program of merging small failing thrifts with healthier acquirors. For example, during the years 1981-83, the number of mergers approved by the Federal Home Loan Bank Board was 858, which was over 70% of the total number of mergers approved from 1980-1987.

The FSLIC's intent behind this program was that the strong management of the healthier institutions would be able to incorporate the operations of the failed institutions and any problems caused by the acquisition would be resolved over a period of time. Former FHLBB Chairman Pratt explained the program succinctly in testimony before a subcommittee of the House of Representatives as follows:

> [B]y using mergers as a supervisory tool when a problem cannot be resolved by cost cutting or securing outside capital, we are seeking to spread as much of the industry's own net worth as possible over the industry's trouble spots as a means of conserving the FSLIC's insurance fund.

Statement of Richard T. Pratt, Chairman, Federal Home Loan Bank Board, before the Subcommittee on Housing and Community Development of the Committee on Banking, Finance and Urban Affairs of the U.S. House of Representatives p.13 (March 24, 1982)

In order to induce larger institutions to acquire failing thrifts, however, the FSLIC had to provide some incentive. Constrained by its lack of funds, one of the primary methods used by the FSLIC was goodwill, which is an intangible asset generated through purchase accounting. Goodwill is generally equal to the amount by which the fair value of acquired liabilities exceeds the fair value of acquired assets and essentially represents the franchise value of the acquired institution. The FSLIC understandably viewed goodwill as an attractive vehicle to facilitate supervisory acquisitions since it is includable as a balance sheet asset under both generally accepted accounting principles ("GAAP") and regulatory accounting practices. The FSLIC therefore used goodwill to boost the capital of supervisory acquirors in lieu of payouts from the FSLIC fund. Many acquirors were induced to merge with failing institutions with little or no tangible assistance, but only goodwill.

According to the FHLBB's annual reports, the FSLIC used the goodwill approach to reduce its present value cost of FSLIC assistance as a percentage of liquidation cost for supervisory resolutions from a traditional 70% to 18% in 1981, 16.3% in 1982 and 37% in 1983. In dollar terms, supervisory acquisitions by companies which are now publicly traded revealed that the FSLIC saved an estimated $11 billion in assistance through the use of goodwill in 1981, 1982 and 1983. Since the sample did not include transactions involving mutual acquirors or merger transactions which were supervisory in nature but did not involve any tangible FSLIC assistance, the actual cost savings to the FSLIC was much higher. Indeed, the use of goodwill postponed the insolvency of the insurance fund for several years. Thus, the FSLIC clearly benefitted from the willingness of supervisory acquirors to accept goodwill. It is worth noting that, now that the "goodwill era" is over, the FSLIC's cost of resolution as a ratio of liquidation cost is back in the 70% to 80% range.

Publicly traded institutions that are supervisory acquirors currently have over $6.6 billion of goodwill on their books. This figure, however, does not include the goodwill created in hundreds of supervisory mergers or acquisitions for which the FSLIC provided no tangible assistance. Total goodwill in the thrift industry today approximates $27 billion, which is over 50% of the capital base of the industry. FAIR estimates that 75% of this goodwill is supervisory in nature.

Goodwill is a nonearning asset since it is intangible and cannot be invested. It is also subject to amortization over time. Thus, a percentage of the goodwill must be taken as an expense each year, thereby reducing net income. Institutions that engaged in supervisory acquisitions and acquired goodwill during the FSLIC's goodwill era were induced to do so since the goodwill, counting as capital and eliminated gradually through amortization, would enable the acquirors to achieve the long term benefits of the acquisitions given time to assimilate the acquired institutions. Both the FSLIC and the acquirors recognized this and acquirors only agreed to the transactions based on the FSLIC's agreement to specified capital and accounting treatment for the goodwill; for example, some acquirors received commitments authorizing 40 year amortization of the goodwill. Indeed, in 1982 the FHLBB withdrew a proposed rule issued under the previous Chairman which would have established strict limits on the inclusion of goodwill in capital and stringent amortization standards for goodwill. This was done specifically for the purpose of facilitating merger transactions. See 46 Fed. Reg. 42274 (August 20, 1981).

Also, the parties typically negotiated supervisory waivers and dispensations intended to allow the acquirors to adjust to the acquisitions without the threat of regulatory action due to the circumstances resulting from the transaction. As the Federal Home Loan Bank Board's memorandum SP-37a indicates, such items are standard components of supervisory acquisition agreements. As recently as January, Bank Board Chairman Wall's written responses to House Banking Committee Chairman Gonzalez reaffirmed the importance of such dispensations in facilitating supervisory acquisitions and minimizing the cost to the FSLIC. Congress has also recognized the importance of these by statutorily granting, in Section 414 of the Competitive Equality Banking Act of 1987 ("CEBA"), a five year extension of such dispensations negotiated in supervisory acquisitions.

There should be no mistake, the capital and accounting treatment of goodwill and the supervisory dispensations and waivers received in supervisory acquisitions were integral components of the strategic and business plans of supervisory acquirors and were specifically negotiated aspects of the supervisory acquisitions. As the Federal Deposit Insurance Corporation's recent study, "Deposit Insurance for the Nineties" noted, the FSLIC's traditional practice has been using goodwill and related regulatory waivers or dispensations to "encourage thrift acquisition[s]" and "marketing or 'selling'" specific dispensations "as an integral part of a complex purchase and assumption transaction." See FDIC, Deposit Insurance for the Nineties: Meeting the Challenge, pp. 182-183. These items were clearly consideration for the supervisory acquirors' acquisitions.

II. THE GOVERNMENT MUST LIVE BY ITS COMMITMENTS AND NOT PENALIZE THOSE INSTITUTIONS THAT HAVE ASSISTED THE FSLIC

Obviously, things have changed in the thrift industry since the early and mid-1980's. The industry has different problems, different causes of those problems and Congress, the

Administration and the regulators are employing different approaches to the problems. However, the Government should not forget those institutions that stepped forward to assist the FSLIC earlier in this decade with little or no tangible assistance and which have lived up to their part of the bargain by taking over sick thrifts.

These institutions, which were described as "white knights" by one congressman for their willingness to assist FSLIC at minimal cost to the fund, were the strong institutions with effective management that the FSLIC saw as prime candidates to take on its problem cases. They are not the cases of fraud, abuse or mismanagement that have made headlines.

In its commendable effort to remedy the problems caused by such fraud and mismanagement, FIRREA would have the presumably unintended effect of breaching agreements negotiated with supervisory acquirors, thereby placing them in a very difficult position, and actually penalize them for having engaged in their supervisory acquisitions. Although Congress or the current Administration may disagree with the policies implemented by previous Federal Home Loan Bank Boards, it is not appropriate to abrogate agreements with individual supervisory acquirors. If the Government determines that a different policy approach is necessary and desires to renegotiate these agreements, FAIR believes that adequate compensation to supervisory acquirors is necessary.

III. FIRREA'S PROPOSED TREATMENT OF GOODWILL WOULD ABROGATE THE GOVERNMENT'S COMMITMENTS TO SUPERVISORY ACQUIRORS AND TURN VIABLE INSTITUTIONS INTO PROBLEM CASES

A. Treatment of Goodwill Under Capital Standards

In this regard, FAIR recommends that several sections of FIRREA be amended. First is Section 314 which would amend the Home Owners' Loan Act of 1933 to require the Chairman of the newly formed Federal Home Loan Bank System ("FHLBS") to establish uniformly applicable capital standards for savings institutions. Such standards must be no less stringent than those applicable to national banks and any deviation from such standards could not result in materially lower capital standards than those applicable to national banks. Goodwill would be included as a component of capital subject to amortization on a straight line basis over a maximum 10 year period. However, the amortization period could be made even shorter by the regulators. The newly issued capital standards would have to be fully implemented by June 1, 1991.

FAIR supports the goal of increasing the capital base of the thrift industry over reasonable time periods. Increased capital benefits the insurance fund by providing a buffer against losses and FAIR's members are fully cognizant of the desirability of raising additional capital. Notwithstanding this understanding, however, FAIR believes that the treatment of goodwill proposed by Section 314 is inappropriate. This treatment of goodwill is wholly inconsistent with the commitments and agreements made by the FSLIC to induce supervisory acquirors to accept goodwill in connection with their acquisitions.

The amortization periods typically agreed to by the FSLIC in supervisory transactions are much greater than 10 years. By requiring goodwill to be written off over ten years (or less if so determined by the regulators) and not exempting supervisory goodwill, FIRREA would abrogate existing agreements and retroactively change the terms which these institutions negotiated in their supervisory acquisitions. It is beyond dispute that supervisory acquirors would not have agreed to accept the goodwill in their supervisory acquisitions if they had been subjected to the treatment suggested by FIRREA, at least not without significantly more tangible assistance and much greater cost to the FSLIC fund. Moreover, the proposed treatment of goodwill would entirely disrupt the efforts of supervisory acquirors to assimilate their acquisitions. The thrust of these transactions was that the acquirors would undertake the acquisitions and the potential for long term benefits in exchange for adequate time to integrate the acquisitions. However, by changing the rules after the transactions were negotiated, the Government would be taking away the time promised supervisory acquirors for the assimilation process.

FIRREA's proposed revision of the amortization schedule of goodwill acquired in supervisory acquisitions would not only be a disavowal of the Government's commitments, it would be bad policy. It would be a breach of faith on the part of the Government with those institutions that were willing to help out the FSLIC and an indication that the Government is not willing to stand by its commitments to supervisory acquirors. It is indeed ironic that while the overall purpose of FIRREA is to restore public trust in the thrift insurance fund, the treatment of goodwill proposed in Section 314 would represent a breach of trust with supervisory acquirors. Further, it would actually penalize institutions that stepped up to assist FSLIC at little or no cost to the insurance fund since institutions that did not similarly step forward to assist the FSLIC do not have goodwill of any significance. FAIR questions whether these are the messages the Government wishes to send at a time when there are still many failed or failing thrifts to be resolved.

Notwithstanding the basic issue concerning the Government's obligation to abide by its commitments, Section 314 would also unnecessarily exacerbate problems in the thrift industry. The 10 year amortization schedule is a luxury that perhaps could be imposed on an already well capitalized industry. However, this approach in the thrift industry is a luxury the Government can ill afford since it would turn viable supervisory acquirors with strong management into marginal cases and could end up costing the Government and the taxpayers billions of dollars. Supervisory acquirors, like other thrifts, are already faced with increased insurance premiums and decreased Federal Home Loan Bank dividends under FIRREA. A 10 year amortization schedule for supervisory goodwill would greatly increase the amount of goodwill that must be expensed each year and make it virtually impossible for supervisory acquirors to generate the income necessary to continue the assimilation process and still meet the increased capital standards.

In addition, rather than attracting new investment to the thrift industry, the approach taken by Section 314 would drive capital away from the industry. By drastically reducing the ability of supervisory acquirors to be profitable, Section 314 would concomitantly reduce the likelihood that such institutions can attract new investment. The Congressional Budget Office recently testified before the Senate Banking Committee that "[w]hile much of the industry may have difficulty generating the added capital internally, it may also have difficulty attracting more equity capital from investors. These institutions may not have significantly bright earning prospects to attract additional investors." Statement of James L. Blum, Acting Director, Congressional Budget Office p.17 (March 3, 1989). The proposed treatment of goodwill under FIRREA is a significant cause of the less than bright earning prospects of supervisory acquirors that would result.

As an indication of this, FAIR refers the Committee members to the attached newspaper article describing the recent decision of Ted Arison, a prominent businessman and a very strong prospective acquiror of Anchor Savings Bank FSB, Hewlett, New York, a supervisory acquiror and FAIR member, to withdraw his offer for Anchor in light of concern over FIRREA's proposed treatment of goodwill. The decision of Mr. Arison to withdraw his offer represents clear and convincing evidence that the strong investors that the industry needs will be repelled rather than attracted by the treatment of goodwill proposed by Section 314.

Thus, the current treatment of supervisory goodwill proposed by Section 314 would create a self-fulfilling prophecy under which supervisory acquirors would be required to increase earnings or raise more capital to compensate for the increased amortization of goodwill, but would be unable to do so because of the same goodwill. FAIR believes that Section 314 should be revised to grandfather existing supervisory goodwill subject to amortization according to GAAP or any special accounting treatment that was negotiated with the Government in specific supervisory transactions. Any other treatment inequitably changes the deals negotiated by supervisory acquirors and raises the serious policy concerns described above.

Notably, the recently adopted risk based capital rules of the commercial banking agencies continue unchanged the treatment of goodwill acquired in supervisory acquisitions of banks. The bank regulators' rules provide that goodwill acquired in supervisory acquisitions of banks will continue to be included as an asset for purposes of computing regulatory capital on the negotiated terms, notwithstanding the agencies' usual policy of excluding goodwill. The banking agencies have stood by the deals that they negotiated with supervisory acquirors of failed or failing banks. FAIR urges Congress to amend FIRREA to ensure that similar respect is accorded the commitments made to supervisory acquirors of failed or failing thrifts.

B. Tangible Capital Standard for FDIC Suspension Orders

Section 902(a)(2)(C) of FIRREA would give the FDIC authority to suspend deposit insurance on any new deposits, including additions to existing accounts and replacements of subsequent withdrawals, for institutions which the FDIC finds, after consultation with the institution's primary regulator, have no tangible shareholders' equity that qualifies as tier one capital under the capital regulations of the applicable agency. The affected institution would be required to notify its depositors of such a supervision order. This provision has been described as a "no growth" provision which merely forces an institution to stop growing. However, FAIR submits that this provision, by suspending insurance on any new deposits, including credited interest, and requiring notice to depositors is tantamount to a closure order.

The use of a tangible capital standard, which excludes goodwill as an asset, in this provision is inappropriate for the same reasons discussed in the preceding subsection. Supervisory acquirors negotiated transactions with the Government under which the acquired goodwill would be included as capital for the purposes of regulatory guidelines and reserve requirements. The adoption of a new statute that could subject a supervisory acquiror to drastic enforcement action, for all practical purposes closing it down, by disregarding its acquired goodwill is inconsistent with those agreements and raises the same concerns previously discussed.

Moreover, the provision disregards the historical use of goodwill as capital in the thrift industry. While Section 902(a)(2)(C) would apply to both thrifts and banks, goodwill as a percentage of regulatory capital for banks is only approximately 2.61% but is 50.7% in the thrift industry. This disparity is due both to the FSLIC's use of goodwill as a form of assistance in supervisory transactions and the fact that significant goodwill is a uniquely thrift phenomenon because of the high percentage of fixed-rate long-term loans in a savings institution's portfolio. Such loans result in much more goodwill when marked to market value under purchase accounting than do the shorter term, variable rate loans in a typical bank's portfolio. Thus, this provision would have a hugely disproportionate impact on thrifts.

Goodwill is an asset includable in capital under GAAP. Its creation is both proper and appropriate and was encouraged by the FSLIC and the FHLBB, which are agencies of the Government, in connection with supervisory acquisitions. Indeed, Congress recognized the validity of the use of goodwill as thrift capital in Section 402(d) of CEBA and even FIRREA, as proposed by the Administration, would contain some grandfathering of goodwill as regulatory capital. FAIR believes that the use of a strict tangible capital standard in Section 902(a)(2)(C) is therefore inappropriate. FAIR suggests that a GAAP standard be used or at the very least that existing supervisory goodwill be grandfathered in the computation of tangible capital.

C. Negotiated Regulatory or Accounting Dispensations or Waivers

Neither Section 314 nor Section 902(a)(2)(C) of FIRREA recognize negotiated supervisory or accounting dispensations. Moreover, Section 302(b) requires the Chairman of the FHLBS to prescribe uniform accounting and disclosure standards for all thrifts to be used in determining compliance with regulations. Such standards are required to incorporate GAAP to the same degree that GAAP is used by the federal banking regulators. To the extent that any negotiated accounting treatment is inconsistent with GAAP, this section could actually be viewed as eradicating existing forbearances.

These items were specifically negotiated with the Government by supervisory acquirors as consideration for the acquisition of failed or failing thrifts and the resulting goodwill to provide time for the acquirors to efficiently assimilate their acquisitions and obtain the long-term benefits. Any attempt to narrow or revoke such contractual items, in addition to raising significant legal issues, would disrupt the assimilation process by possibly subjecting supervisory acquirors to operational restrictions or even serious enforcement action due to circumstances arising from their acquisitions. It should again be stressed that these are specifically negotiated items acquired as consideration for acquiring failed or failing thrifts. FAIR suggests that

Congress ensure that the letter and spirit of all negotiated dispensations be respected by statutorily requiring the agencies to give substantive effect to negotiated items of this nature.

IV. FAIR IS NOT SEEKING SPECIAL TREATMENT OR REGULATORY WAIVERS; ONLY THAT THE GOVERNMENT LIVE UP TO ITS COMMITMENTS

FAIR emphasizes that supervisory acquirors are not seeking special treatment. They are only asking that Congress recognize the terms and conditions of the agreements they negotiated with the United States Government and not penalize those acquirors that were willing to assist the FSLIC in handling its supervisory problems.

In any event, FAIR also notes that the changes it is suggesting will not affect the ability of the federal regulators to control unsafe or unsound practices or other problems. The regulators have extensive enforcement authority to control unsafe and unsound practices, authority that would be further enhanced by FIRREA and which is entirely unaffected by the amendments to FIRREA that FAIR is recommending. FAIR's amendments would enhance the viability of supervisory acquirors without constraining the regulators' flexibility.

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